THE CAPITALIZATION OF GOODWILL

BY

KEMPER SIMPSON

A DISSERTATION

Submitted to the Board of University Studies of The Johns Hopkins University in conformity with the Requirements for the degree of Doctor of Philosophy

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PREFACE

This monograph had its origin in an investigation carried on by the author while a member of the economic seminary of the Johns Hopkins University. The actual material was obtained for the most part from bankers actively engaged in the flotations described. Mr. Henry Goldman of Goldman, Sachs & Co., New York, and Mr. Abel Rosenburg of Frank, Rosenburg & Co., Baltimore, aided the author in obtaining material and information. Acknowledgement is made to Merrill, Lynch & Co., to Ladenburg, Thalmann & Co. of New York, and to Stein Bros. of Baltimore. Finally, the author wishes to express his appreciation of the helpful criticism received from Professor J. H. Hollander, Professor G. E. Barnett, and from the other members of the economic seminary in the Johns Hopkins University. Some of the data in the first two chapters was presented in entirely different form in articles in "The Annalist."

K. S.

THE CAPITALIZATION OF GOODWILL

CHAPTER I

Introduction

In the United States during the last decade there came into prominence a type of industrial corporation, the study of which constitutes an important part of the field of corporation finance and takes on perhaps even a larger significance from its economic implications. The emergence of a new type of corporation was the accompaniment and the result of a new and changed economic condition. A glance at the quotations of any of the stock exchanges of today will disclose a considerable number of proper names in the titles of the corporations represented. Sears Roebuck, Studebaker, Julius Kayser, Willys-Overland, and F. W. Woolworth appear along with the United States Steel Corporation, the United States Rubber Co., and the International Harvester Co. The appearance of these proper names on the stock exchange has an interesting economic significance. These companies had been for the most part originally private businesses begun in a small way by the men whose names they bore. As these businesses grew, most of them were incorporated in order to obtain the legal advantages of the corporation and to escape the inconveniences of the partnership and of the private business. These incorporations, however, ordinarily brought about no change in the methods of financing employed. Later, as these businesses expanded they found difficulty in financing themselves in the usual way through the commercial banks, or their owners desired to withdraw their capital investments. They were then reincorporated in order to issue seven per cent stock to be sold on the stock exchange.

The rise of this new class of industrials is associated with the increasing size of the industrial business unit, and with the extension of the once limited field of incorporation and of corporation finance. It is doubtful, however, whether these businesses would have assumed the form they did, and whether such reincorporations would have spread in the way they did, had it not been for the investment bankers. The other fields—railroads, public utilities, and industrial combinations—had been so thoroughly exploited that this new type of flotation was eagerly sought. The more important events in corporation finance since 1890 may be enumerated as follows: the spread of combination between 1886 and 1890; the enactment of the Sherman Anti-Trust law of 1890; the ineffectiveness of this statute for twenty years after its passage; the failures and reorganizations of the great "trusts" from 1900 to 1905; the panic of 1907, followed by reaction and than by the prosperity of the years from 1910 on; the anti-trust activities which started in the Northern Securities Case and which culminated in the Standard Oil and Tobacco decisions of 1911; and the rise of the new flotations here considered in 1911 and 1912. For a number of reasons, the last of these events is logically connected with the preceding events.

There was more than one motive which influenced the owners to reincorporate their businesses for purposes of flotations. The economic background and the part which the bankers played—as well as the motives of the owners—are considerations of importance and will be discussed in detail in this study. From one point of view, these businesses were reincorporated merely in order to sell preferred stock. Incorporations of this kind were not brought about by the desire for combination, nor were the purely legal advantages responsible. Most of them were purely financial expedients, and as such were somewhat different from the corporations that had existed before.

These industrial corporations constituted a definite class of corporations, not merely because they came at the same time, because they were the results of the same motives,

and because they had the same purposes, but because of their great similarity in form and in construction. The actual mechanism of the flotation was so simple and so much the same in most instances that it can be explained here in a few words. Whether the banker approached the successful business man or whether the owner sought out the banker, the process was practically the same. The owner sold his business to a newly created corporation, which paid him an issue of seven per cent preferred stock and an issue of common stock. The preferred stock was supposed to bear some definite relation to the tangible assets, and was usually covered by them. Behind the common stock something, known variously as "goodwill" or earning power, was supposed to stand; as a matter of fact, the common stock was justified solely by the knowledge that the business earned or was hoping to earn more than enough to pay the preferred dividends. Sometimes second preferred stock was issued, and sometimes bonds; but this was not typical and was the result of unusual circumstances. The preferred stock was sold in the market and the proceeds were used in the different ways already described. The owner held the greater part of the common stock and with it the control of the business. The banker, who was usually paid for his work by a common stock bonus, would sometimes market his block of common, thereby "creating an appetite for that particular kind of stock so that if in the future the owner wanted to dispose of a part of his holdings there would be a ready market for it." Of course, there were many exceptions to the rule, but on the whole the essential features of these industrials were the same. An issue of seven per cent preferred stock, marketed through one of a few well known investment bankers, an issue of common stock held, at least for a short time, by the men who were responsible for the success of the business, and an almost stereotyped method of capitalization were the criteria of the class.

One of the most distinctive features of these corporations was the kind of preferred stock which they created. There

had been preferred stocks before, and there had been preferred stocks guaranteeing from four per cent to as high as ten per cent, but there had never been a class of cumulative preferred stocks to which there had been appended such a series of carefully worked out provisions of a marked similarity. A seven per cent industrial preferred stock came to mean something almost as definite as a United States government bond. Industrial corporations, very similar in structure to these, existed before the issues of Sears Roebuck and the United Cigar Manufacturers were floated in 1906. But, as a class, these industrials have existed only for a little more than a decade; and they have been a factor of importance for only about half of that time.

Naturally, the short time these companies have been in existence makes it difficult to form any satisfactory judgment of their success. Furthermore, the number of companies which conform strictly to the type is not nearly so large as it promises to become. Many companies, which were exactly like the typical examples already described, did not market their preferred or common stock on the public exchanges. Many companies, which might have been listed on the smaller exchanges and eventually on the New York Stock Exchange, sold their stock privately. These companies were, for the most part, smaller; but this was not always true.

From the theoretical economist's point of view these incorporations have an especial interest since they represent a definite division between the functions of the entrepreneur and of the capitalist. In the typical capitalization of this class, the preferred stock holder is the capitalist and is paid interest. The high rate is probably explained by the risk involved; when the risk is not great, he pays more than par for the stock. He assumes the capitalist's function which the original owner in some cases entirely surrenders. (The accountant's misconception when he treats preferred dividends different from bond interest is apparent). As long as the original owners hold the common stock, they perform a purely entrepreneurial function. In

some cases it was definitely provided at the time of incorporation that the original owners, who had been responsible for the success of the business, must retain their common stock holdings for a certain period.

The subsequent sale of the common stock by the original owners represents one of the most important problems of these flotations. So long as the common stocks are closely held by the original owners, it makes no difference into how many shares they are divided. But the sale of the common stock in the market represents the social capitalization of a large amount of industrial goodwill. The sale of a part of the common stock, however, does not mean the surrender of the entrepreneur's function, because the entrepreneur's function implies control. Common stock is entitled to vote, but a small holding of common stock does not represent very much of the entrepreneur's function. The sale of a small block of industrial common stock is not very different from the sale of preferred stock. Common stocks so sold might be thought of as second preferred stocks, except, of course, that they have no preference as to income and assets. Inasmuch as the risk inherent in these common stocks is usually considerable, they ordinarily sell at low prices. The purchaser of common stock who buys for investment, and not for the purpose of exerting control or direction, has little of the entrepreneurial function.

The sale of these industrial common stocks, then, is the sale and capitalization of goodwill. Of course, a part of the preferred issue may have no actual investment behind it, but this is unusual. The sale of the preferred stock could be justified as the sale of the original investment, but the sale of the common stock is more difficult to justify. The entrepreneur's share is thereby transferred into a capitalist's share. The consequent claim upon the invested capital of society in many cases cannot be justified. These flotations have often made possible a gross over-capitalization of industrial goodwill.

When the entire common stock is sold by the original-

owners, the possibility presents itself that the investor in preferred or common stock has purchased a security less safe than he was led to believe. For this reason, prudent investment bankers usually insist that the men who have been responsible for the success of a business must not dispose of their common stock holdings, and must take the same interest in the companies as they did before their investment was withdrawn. As investments, the first preferred stocks have proved their value. The same, however, cannot be said for the majority of the common stocks.

CHAPTER II

The Development of a New Type of Stock Flotation

The reasons why men have preferred the corporate form of business organization to the partnership have been much the same throughout the history of industrial corporations. First, there was the perpetual succession made possible by legal authority and the dignity lent by governmental concession. Second, the corporation was the usual form employed by men who desired to obtain the control or the monopoly in a certain trade or in a particular industry. Third, the corporation is superior to the partnership as a method of financing a venture which requires a considerable amount of capital. In the different epochs in the history of corporation finance, however, these different motives have not always had the same importance.

The earliest corporations in England were the result of certain institutions and ideas which were vital in the economic organization of the Middle Ages. The corporate idea was developed in the mediaeval guilds, where "the conception of perpetual succession was implicit."[1] The internal government of the guilds and their jurisdiction in economic affairs are important in understanding the rise of the regulated companies, which were practically guilds of merchants engaged in foreign trade. Just as in the case of the merchant guilds, these early companies had a more or less exclusive control of the trade in which they were interested. It was with the joint-stock companies that corporation finance emerged. These companies, which carried on foreign trade and later manufacturing, undertook ventures which individuals could not have financed. Shares were thus created; and those who financed the ventures, the shareholders, were capitalists as well as entrepreneurs.

[1] W. R. Scott, Joint-Stock Companies to 1720, vol. i, chap. i.

The dignity adhering to the corporation, which was evinced by the common seal and the crests of the earliest companies, was a feature which it is hard to overestimate. As a matter of fact, not all of the joint-stock companies had control of the trade in which they were engaged; and, later, monopoly became unusual. Furthermore, corporation finance as it is understood today was not possible until the limited liability provision was developed in the middle of the seventeenth century.

The use of the corporate form of organization to control trade or industry was exemplified at a much later epoch in the history of industrial corporations. This use of the corporate form was popularly known as the "trust movement," and played one of the most important rôles in the economic history of the United States. In England, in the early years of the eighteenth century, the United East India Company was formed as a consolidation of seven different organizations.[2] But the so-called trust movement in England came at about the same time as in the United States, and that was not until after the Civil War. Simeon Baldwin's list of private incorporations in the United States before 1800 records but 225, of which only 12 were devoted to manufacturing. Between 1800 and the Civil War the expansion in our industry necessitated a more extensive use of the corporate form in industry, but it was not until about 1860 that the industrial combination and trust movement became a feature in our national life.[3] Starting with the pools in the cordage industry in 1860, combination spread over all industry. The formation of an employers' association, or even a chance social gathering of men, influential in a particular industry, led not infrequently to agreements and common rules. A loose combination of some kind was inevitably the next step. Only a short time elapsed before the advantages of the corporate methods of financing in the formation of such combinations were recognized and made use of wherever possible.

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[2] Ibid., vol. i, chap. xix.

[3] W. H. S. Stevens, Industrial Combinations and Trusts, The Macmillan Company, 1913, p. i.

In the period from 1860 there were two kinds of incorporations which brought together separate properties: there were those by which a number of businesses already in operation were combined, ostensibly to obtain the advantages of large scale production, but actually, in most cases, to effect a monopoly; and there were those incorporations which were developed by men who saw the possibility of the development of an industry and who bought up the necessary properties from those who had owned them. In the first class, the idea of combination might have occurred to the owner of one of the combined businesses; nor is it necessary to think of an outside promoter as a factor in the combination. But in the second class, the outside promoter was usual. That one of these methods was as common as the other suggests the reason why the inside promoter and the outside promoter came to be thought of as equally probable contingencies. This fact is important in understanding the class of promotions which constitute the subject of this study.

It appears that it was as far back as 1865 that the combination in oil was first begun, and though it was begun in a small way, the economic organization in which it was placed was a rapidly expanding one. The industrial depression from 1873 to 1877 made people consider the evils of economic organization, and the combinations came in for their share of criticism. The Standard Oil Trust was formed in 1882, but this was a mere formality as the trade had already been monopolized long before. Other trusts sprang up, and in 1885 Congress gave up its former attitude of non-interference with private matters and abandoned its laissez-faire policy. After two years of discussion the Interstate Commerce Act was passed. This was followed in 1890 by the Sherman Anti-Trust Law, which has been called the most important statute in our history. The excitement it caused was only equalled by that in the Dred Scott case; however, its effect was far less important than might have been expected. Walker, in his book on the history of the Sherman law, has summarized the results

attained under this law for each administration.[4] The conclusions of his chapters will be presented in order to show the results of the passage of this act.

The Sherman law was passed in 1890 during Harrison's administration. He was president thirty-two months after it went into effect. Walker states: "It is apparent that the Sherman law was never used to any considerable extent as an instrument for the promotion of justice, or for the prevention of injustice, at any time prior to the end of the administration of President Harrison." In Cleveland's administration, eight of the ten cases under the law were concerned with labor organizations. Walker's analysis of these cases shows that the practical effect of this law in the four years from 1893 to 1897 was insignificant. "The eleven litigations relevant to the Sherman law between private parties which occurred during McKinley's administration (1897–1901) included eight cases in which that law was invoked in vain, and two cases in which it was successfully invoked by the defendants, and only one case in which it was successfully invoked by a plaintiff on a complaint as a means of remedying a wrong which had been inflicted by the defendants in violation of that law." Walker says: "Not even one 'trust' accurately so called was ever prosecuted prior to the end of McKinley's administration for violation of the Sherman law; and only two such prosecutions were begun prior to that time against any holding company, as if they were trusts."

The financial straits which led up to the panic of 1893 and the monetary difficulties thereafter would suggest that this was no period for promotions of any kind. Between 1890 and 1893, however, the starch, the leather, and the cordage consolidations were effected. The victory of the gold party in 1896, the trade revival in 1898, and the railroad and industrial expansion that followed were accompanied by a considerable number of combinations; yet no interference from the Sherman law was encountered. In the Northern Securities Case (1902–1904) there appeared

[4] A. H. Walker, History of the Sherman Law of the United States of America, 1910.

in the courts for the first time an effective anti-trust feeling. The final culmination of this feeling came about in the Standard Oil and Tobacco decisions of 1911. Aside from the effect on judicial opinion of the trust abuses, there was growing in the minds of the people a feeling against combination engendered by the great number of failures between 1900 and 1907. Two-thirds of the combinations that Dewing describes failed or were reorganized in the first years of the century.[5] The Rich Man's Panic and the Armstrong Investigation aroused further the public distrust of "big business." The bad effects of the panic of 1907 had hardly worn off before the Standard Oil and Tobacco decisions convinced bankers and investors that a combination of competing businesses was, at best, a doubtful basis for the issue of securities.

A new class of industrials invaded the stock market in 1911 and 1912. These industrials were incorporated private businesses or reincorporated closed corporations formed for the purpose of issuing stock and selling it in the market. Before this many private businesses and partnerships had been converted into corporations because of the very obvious legal advantages to be gained, but the sale of a business to a corporation in return for an issue of stock to be listed on the exchange was at that time a new thing. Prior to 1900 some well known businesses had been incorporated and had issued preferred stocks to be sold in a limited area. Some few small private businesses that had been converted into corporations were listed on the exchanges of the Middle West; between 1900 and 1906 they increased considerably. Among these a few small issues of department stores are noteworthy.

In 1906 Mr. Henry Goldman, of Goldman, Sachs and Co., brought out the United Cigar Manufacturers and Sears Roebuck. Before the panic of 1907, this banker had appraised the value of a great private business as the basis of a flotation, and the New York Stock Exchange became

[5] Arthur Stone Dewing, Corporate Promotions and Reorganizations, Harvard University Press, 1914.

acquainted with a new kind of industrial corporation. For a few years after the panic any activity of this kind would have been impossible, but with the coming of better times in 1910 a few promotions appeared, the most notable of which were the work of Mr. Henry Goldman. It was in 1911 and 1912 that industrials of this type first became prominent. They may be considered as constituting a distinct class of corporations, and as representing a new epoch in corporate development. Some of the same motives which actuated the earliest incorporations are present, but in different degrees. As the historical study shows, these flotations were in a large degree the result of the reaction against combinations. Naturally, they have not that feature which has been so often associated with the corporation, that is, the control of the trade or the industry. The primary motive of the incorporators of these industrials is the desire to obtain the financial advantages which the corporate form of organization offers. It goes without saying that often the legal advantages of the corporation have a large appeal for the ordinary business man. Of course he can incorporate and have perpetual succession without selling stock on the exchange, but it is partly the importance and the dignity attaching to a public flotation that influences him. Moreover, the advertising value in being listed on the exchange is considerable.

The history of the spread of these companies in 1911 and 1912 and the subsequent growth of the movement is not only interesting but is also valuable in the solution of one of the most important problems dealt with in the following chapter,—the motives of the incorporators. The particular question on which the history throws light is whether it is the banker or the owner who is to be held responsible for the rise and spread of these industrial corporations.

In 1912 the B. F. Goodrich Co. was reincorporated with the issue of ninety million dollars of stock.[6] Shortly before this, the bankers, Goldman, Sachs and Co., had planned the reincorporation of B. F. Goodrich with about forty-five

[6] See appendix iii.

million dollars of stock. That the flotation, as finally put out, was twice as large as the one originally proposed is explained by the fact that meanwhile the Diamond Rubber Co. approached the same bankers with a view to incorporation, or rather, reincorporation. These bankers brought the two competitors together and finally combined them in one company. In the interval between the incorporation of the original B. F. Goodrich Co. and its acquisition of the Diamond Rubber Co., the Goodyear Rubber and Tire Co. was reincorporated. The Goodyear flotation and the Fisk flotation, which followed in October of the same year, were the work of William Salomon & Co. From the five million dollars' worth of preferred stock issued by Goodyear, four million dollars were obtained by the business for working capital; from the three million dollars of preferred stock issued by Fisk, two million, four hundred thousand dollars were returned to the business, avowedly for working capital, partly perhaps for the liquidation of indebtedness.

The spread of flotations in the chains of five and ten cent stores started when in January, 1912, Goldman, Sachs & Co. brought out the F. W. Woolworth stock.[7] This was the first of the five and ten cent chain flotations; its beginnings have an almost romantic interest. The men who owned the several chains that were combined in this flotation grew up together in the same little town. They had always looked forward to the time when this combination might be effected. When an incorporation was suggested to them they were in a thoroughly receptive mood. There seems to have been no particular need for this kind of financing except as a method of allowing the owners to withdraw their investments of capital. Later in the same year the Kresge flotation occurred. The purpose of this reincorporation was the withdrawal of capital. The sale of preferred was neither for expansion, nor for liquidation. Whether Kresge, emulating Woolworth, sought out the financiers, or whether they went to him is an unessential consideration. It is enough to say, that the movement in this field that was

[7] See appendix iv.

started by the bankers resulted in the Woolworth, the Kresge, and, a few years later, the McCrory flotations.

The incorporation of the private businesses in manufacturing agricultural implements started in 1911.[8] In that year William Salomon & Co. brought out Rumely preferred. The grandson of the original founder had been induced by the bankers to consider the possibility of a flotation. In the next year, 1912, four of the largest businesses of the same kind were incorporated, or reincorporated, Emerson Brantingham, J. I. Case, the Moline Plow Co., and Deere & Co. In a so-called "Special Memorandum" of Emerson Brantingham the following words occur: "The acquisition by the Emerson Brantingham Co. of the assets and businesses of these various companies is the natural result of the rapid changes which are taking place in agricultural methods and the implement industry." As "working capital" was acquired in practically all of these incorporations, this excerpt from the Emerson Brantingham prospectus is to be regarded as significant.

The financial depression which accompanied the opening of the European War stopped the spread of these incorporations, but only temporarily. The great era of prosperity which followed, when America came to be the producer for the world, stimulated these promotions in a spectacular manner. Businesses of a kind which had never been thought of as stock market possibilities were made the bases of flotations. The bankers have sought out the great merchants; and the merchants have approached the great bankers.

[8] See appendix i.

CHAPTER III

The Motives of the Owners and the Bankers

It is necessary to consider the promoter of these industrial corporations and his function before the motives which are responsible for the existence of these corporations can be understood. The pure promoter, the outsider who merely proposed the scheme to the owner and who interested the bankers, was usually not a factor in these flotations. The work of bringing together the different units which constituted a combination had furnished a justification for the outside promoter; but when enterprises in which there was nothing to combine were to be incorporated, the most important function of the outsider disappeared, and with it his excuse for existence. Some of his other functions were important, but these, it is easy to see, could be readily assumed by others. Discovering the business organization and obtaining the underwriting syndicate were other necessary services which formerly were assumed to be, in most cases, the duties of the pure promoter. The occupation of the promoter was attractive because his remuneration was considerable. It was, therefore, only natural that those who were forced to pay for his services considered the possibility of assuming his functions. The banker coveted a part of these profits. This interest of the banker proved effective in many cases in that he was able to develop that specialized knowledge which many promoters had, but which was beyond the capability of ordinary business men. Finally, the banker had always been such an integral factor in the process, and had so definite a function in his own right, that it was perfectly natural for him to assume the other duties of the promoter.

Although the pure promoter can be disregarded in a study of these flotations, there still remains the important question as to whether it was the banker or the owner

who is to be considered responsible for the actual promotion. There are really two issues involved in this question. First, was it the banker or the owner who took the initiative in the greater number of cases? Second, was the movement as a whole the result of the activities of the great investment bankers or was it brought about by the great merchants? In every promotion the banker must play a very definite rôle; but it seems somewhat unwarranted to call him the promoter, unless it was his initiative that was responsible for the incorporation. It might be established that in the large majority of cases the banker was not promoter in this strict sense, and there would still remain the important question as to whether, in a more general way, bankers have been responsible for the general rise and spread of these promotions during the last ten years. It is impossible to give a dogmatic or unqualified answer to either of these questions. It would seem that the answer to the first question could be determined by actual count, and that the answer to the second would emerge in the history of the movement. If the testimony of the most reliable investment bankers can be accepted, the number of cases in which the bankers sought out the owners has been about equal to those in which the owners sought out the bankers. The second question, although more difficult to answer, admits of a more definitive settlement. It seems reasonably clear from the historical description presented in the foregoing chapter that the rise and spread of these industrials in 1911 and 1912 resulted primarily from the activities of the great investment bankers.

The view suggested above that bankers sought out large successful businesses as a basis for flotations when their former sources of supply, that is, combinations, were no longer available, however, like most views needs qualifications which will be best set in their proper perspective by some consideration of the other views as to the genesis of these corporations.

One set of these theories is associated with the motives of the owners. "The owners of successful businesses after

reaching a certain age wish to incorporate and they seek the necessary financial agents in order to withdraw their capital and, at the same time, retain the management," was a suggestion offered both by a student of corporation finance and by a shrewd investment banker. The student suggested that in a majority of cases the incorporations would be found to have occurred about twenty years after the founding of the businesses. The actual facts show there is no uniformity in the number of years that elapsed before incorporation, and that if there is any number of years more common than others it is somewhere around forty. Furthermore, it is clear that there are comparatively few incorporations for which the withdrawal of capital was the sole motive. Finally, often when the withdrawal of capital was effected, it appears that it was in the nature of an inducement offered by the promoting banker rather than the motive of the owner which made them seek the banker.

A second theory of this kind emphasizes the fact that in the great number of promotions of 1911 and 1912 the acquisition of capital for expansion or for the liquidation of indebtedness was sought. It suggests that the industrial expansion and the difficulty of obtaining capital in those years induces owners of well known businesses to incorporate. Although this theory does not explain the promotions prior to 1911 and 1912, and although it is known to be insufficient for many of the incorporations of those two years, it undoubtedly has a value which should not be neglected. Many of the companies incorporated in 1911 and 1912 sold their preferred stock issues, or parts of them, to obtain "working capital for expansion." Some of the most prominent issues of those years were of this kind. The Fisk Tire Co., The Brown Shoe Co., the Julius Kayser Co., and the Loose Wiles Biscuit Co., gave this as the principal reason for their issues. One half of the Studebaker preferred was returned to the business for working capital; Goodyear Rubber Tire Co., and Moline Plow Co. wanted capital both for expansion and for the liquidation of indebtedness.

It seems reasonably clear that the bankers first taught the merchants the value of this kind of financing. The spread of incorporation in the industries, described in the foregoing chapter, shows how the merchants profited by the examples of their competitors. The bankers' initiative, displayed in the Goodrich, the Woolworth, and the Rumely flotations, resulted in the spread of flotations in those industries. But this theory of the initiation of these promotions does not preclude the possibility that it was usually the owners who were the seekers and the bankers who were sought. Some of the bankers maintain that the flotations which were the result of their initiative have been, generally speaking, the more successful ones. Important as were the bankers in the general movement, the motives of the owners to whom they had to appeal and the motives which led so many owners to take the initiative deserve as much attention and as detailed study as the motives which impelled the bankers.

One of the reasons why the bankers started these flotations has been sufficiently treated; they wanted large, successful, private businesses as bases for flotations at a time when prosperity and expansion encouraged stock market promotions and when combinations were considered unsafe and illegal. The most successful of these bankers had done a mercantile credit business which gave them a knowledge of the conditions in different industries; and it was this knowledge which enabled them to choose the proper businesses when they saw that the market could absorb new securities. There was another, perhaps more definite, consideration which influenced them in the direction of their activities. In this particular kind of flotation a large amount of "watered" common stock was always issued. At the time of the issue this common stock usually had but little value, since the earnings of the businesses were seldom large enough to warrant any dividends on the common stock. The bankers, however, took payment for their services in large common stock bonuses, since they saw that with the growth of the business the common stock would become more and more valuable.

The arguments, which the bankers employed to justify these large common stock bonuses and to convince unwilling owners to part with so large a share of their businesses, were apparently the following. First, said the bankers, we are the promoters and as such deserve a considerable remuneration. Second, when our customers buy the securities which we offer, they must have some assurance as to our knowledge and our ability to control or to regulate, in some degree, the conduct of the businesses which we float. When we sell an issue of stock, our reputation is dependent upon the success or failure of the business which underlies that issue. Our only effective method of supervising these businesses is through the voting power which attaches to the common stock. Third, although it is to the interest of everyone concerned (the bankers, the investors, and the owners) that the men who are responsible for the success of a business should retain their common stock as long as possible (and with it their control and interest), there will come a time when they will have every justification for wishing to dispose of their holdings of common stock in the market; and this legitimate desire can best be fulfilled if the bankers be given a large enough block of common stock so as to sell it or a part of it at the time of the flotation and cultivate the market's taste for that particular kind of stock. These were the arguments which enabled the bankers to obtain the enormous stock bonuses which, it appears, they received.

The motives which were effective in making the owners desire these flotations and the inducements which the bankers held out to the owners whom they wanted to interest were of many kinds. Although the purely financial advantages offered by these flotations and the possibility of capitalizing their goodwill were the most important considerations, there were others which can not be neglected. Just as the crests, the common seal, and the other dignities which attached to the early corporations made the men of the Middle Ages prefer the corporate form and its perpetual succession to the private business organization, so the fact

that a business was listed on the New York Stock Exchange made a large appeal to the ordinary American business man. A private business obtained in this way a considerable advertisement, and was helped materially in the development of its trade name.[1] The fact that F. W. Woolworth was quoted on the New York Exchange may have had some effect on Kresge or McCrory. The success of Studebaker and of Hart, Schaffner and Marx, as stock market ventures, stimulated other promotions in the automobile and clothing industries. The spread of these incorporations in the rubber and agricultural implement industries and in the chains of five and ten cent stores must be explained in part as due to this motive.

It must be clearly understood that seldom was any one motive entirely responsible for a flotation. Even where there was one motive which was clearly predominant, there were others which were contributory. In the numerous cases where the banker's motive was simply the desire for monetary profit—where the business floated was not a really sound basis for this kind of promotion—the inducement or inducements to incorporation which influenced the owner must not be neglected.

One of the great advantages which has been associated with the corporation throughout history was not present in these industrials. Many of the earliest corporations were granted an exclusive right to a certain trade. A number of American corporations in an earlier period had obtained what was practically the same result by combination. The industrials included in this study could attempt no control of an industry. The casual observer might point to the fact that many of them were combinations, that is, Woolworth, Kresge, McCrory, Kresge, Jewel Tea, Acme Tea, May Department Stores, etc. These combinations, however, were very different from those of the trust movement. The two purposes of combination are the control of an industry (maintained by the stifling of compe-

[1] This advertisement value was recognized by Goodrich, Sears Roebuck, and Underwood Typewriter.

tition) and the advantages of large-scale production (made possible by the law of increasing returns). But the courts forbade restraint of trade; and investors became skeptical as to the advantages of large-scale production after the failures in the first part of the century. The new industrials were combinations of non-competing businesses, and as such did not come into conflict with the Sherman law. The organizations combined were retail and for the most part in different cities. Furthermore, it is obvious that practically none of the advantages of large-scale production were possible in this kind of combination. Indeed, these businesses, which were owned in most cases by the same man or group of men, did not require a flotation or even incorporation in order to be combined; nor was combination ever a motive which was effective in bringing about the promotion.

This class of industrials was distinguished from those that went before by the fact that the purely financial advantages of flotation influenced the owners of these businesses. There were some industrials which came at the same period, and which had the same form as those in this class; but they were different in that they were not private businesses incorporated or corporations reincorporated. They started out as corporations and with a public issue of stock, which was intended to obtain capital for the initial financing.[2] The new industrials were all private businesses incorporated, or closed corporations reincorporated, which issued and sold preferred and common stock in the public market.

The sale of preferred stock, then, ordinarily had one or more of three purposes: (1) the withdrawal of the owner's capital; (2) the acquisition of working capital for the expansion of the business; (3) the liquidation of the indebtedness of the business. These were the three motives of the owners, which the remainder of this chapter will treat in some detail.

The desire to withdraw capital is the motive which some have held to be solely responsible for the rise of these

[2] E.g., United Five and Ten Cent Stores; Burt Olney Canning Co.

corporations. As was explained before, this view is unsound; sufficient proof of this contention is found in two facts: (1) this motive was not effective in the earliest flotations; (2) in very few cases was it the sole inducement for the later incorporations. However, in practically every industrial corporation there was some withdrawal of capital, even in cases in which expansion of business or liquidation of indebtedness was the motive which really brought about the flotation. Finally, in all those flotations where the only financial consideration was the withdrawal of capital, it was either the banker's initiative or the psychological effect of other flotations on the minds of the owners that was really effective. Examples of this type were Woolworth, May, Kresge, Goodrich, and Rumely.

The withdrawal of capital was seldom set forth in the prospectus as one of the reasons for the sale of preferred stock. It may have been assumed that the investor would understand that any capital, which was not intended for expansion or for liquidation of indebtedness, was to be withdrawn. However, it is more likely that this reticence was due to the belief that the ordinary investor would not have approved such a withdrawal. He would have felt that the owner was trying to withdraw his capital, and yet keep control of the business that was being financed by the money of other people. The answers which companies like Woolworth, May, and Kresge, could have given might have been convincing; yet the absence of any definite avowal of this purpose in most prospectuses is evidence that it was considered advantageous not to present it.

The second motive which influenced owners to incorporate was the desire to obtain working capital for expansion. The advantage of borrowing from the public when compared with borrowing from the commercial banks was recognized in many cases as very considerable. The loan could be made for a long period, and the company's credit was thereby increased at the bank. Shortly after Rumely and Goodrich were reincorporated there was a spread of

flotations in the agricultural implement and the rubber tire industries. This may have been suggested by the example of those first two incorporations; but the fact that the other companies needed capital for expansion in the years 1911 and 1912 is important.[3] Although the general need for expansion in those years was not the sole explanation of the interest of the owners in these flotations, it is reasonably clear that this motive played an important part.

This motive was the one which the prospectuses were most willing to acknowledge. Expansion or the need for capital, throughout the history of corporation finance, has been considered a justification for a public sale of stock. In England, although an issue of debentures in the original financing of a company might have been questioned, such an issue was considered quite the proper method of obtaining capital for expansion later in the company's history, and preferable to making a call on the original stock holders. Expansion seemed the legitimate criterion of a successful business, and the need for working capital was one which investors were expected to be willing to satisfy. In some of the prospectuses of the new industrials, the alleged "working capital for expansion" was really intended for the liquidation of indebtedness. Naturally, this liquidation of indebtedness increased the credit of the company at the banks, and thus established the possibility of expansion. It is a question, however, whether the investor who believed that his money was to be used for expansion would have been equally satisfied if he had known that it was to be used for the payment of debts.

The fact that these industrials did increase rapidly in a time of business expansion gives great importance to the second motive. As soon as the country had recovered from the economic prostration attendant upon the panic of 1907, these industrials began to appear. Again when it was realized that the European War would mean great prosperity for the United States, the market teemed with these

[3] See below, p. 84.

industrial issues. Certainly the proceeds of much of the preferred stock that was sold went into expansion, the purchase of new machinery, etc. And it is just as true that much of the money which it was believed would be used for new working capital was employed to pay off debts which were the result of rapid expansion.

The third motive, the liquidation of indebtedness, is one of peculiar interest. It might seem that the company in issuing preferred stock to pay off existing indebtedness was borrowing from Peter to pay Paul. But, although seven per cent was a high price, the terms were far better for the borrower. There was no need to renew the notes as they fell due; and small investors were easier to manage than the bankers. Furthermore, bankers as stock holders were allies; but bankers as creditors had not always been so friendly. It is easy to see how this motive led to incorporation. When a merchant needed a sum of money for some debt or other, he approached the banker. Goldman, Sachs & Co. had done a credit business of this kind long before the rise of these industrials. The banker discussed with the owner the value of a flotation as a method of obtaining money. This was an important motive in the Sears Roebuck incorporation. In some cases the banker used as one of his arguments, when trying to induce an owner to incorporate, the possibility of converting large outstanding liabilities into a preferred issue. Stern Bros. changed a bond issue into an issue of preferred stock; but it was for reasons of taxation and not for the purpose of improving its credit. However, in the J. I. Case flotation one of the reasons—and perhaps the principal one—for the preferred issue was the cancellation of a large bonded debt. In the Manhattan Shirt Co., the Moline Plow Co., and in Henry Sonneborn Co., this motive was of great importance.

CHAPTER IV

The Method of Flotation

In most studies on corporation finance, much has been made of the technic of the underwriting. The actual mechanism of the new flotations and the modus operandi of the creation and the disposal of the preferred stocks in the new industrials was not particularly complicated and is of interest merely because it shows the way in which the banker-promoter received his remuneration. The sale of the business to a newly created corporation, which has been described elsewhere, was a comparatively simple process. A corporation was formed which bought the old business from its owners, and in return gave them the issues of preferred and common stocks. The former owners were then in entire possession of the preferred and common stocks. So much for those flotations wherein the owners withdrew their capital. In those cases where the sale of preferred stock was partly intended to obtain money for the business, there was another possibility. The corporation might have given the owners the entire issue of common stock, but only a part of the preferred issue. The part which the new company retained could then be used to procure the new capital necessary. In some cases, however, the owners received all the stock; but after they had disposed of it, they returned a part of the proceeds from the sale of this stock to the new company in return for its note.

It was with the holders of the stock, namely, the former owners of the business, that the banker-promoter dealt. The banker-promoter, alone in most cases, or with one or two associates, bought the entire issue of preferred stock. One of the leading banker-promoters in the field said: "We bought for our own account and at our own risk from

the stock holders of the new company (not from the company) all or a part of the Preferred Stock, with a bonus of Common Stock." So far no underwriting was done, and no syndicate organized. In this respect, the purchase of an issue of seven per cent industrial preferred stock differed from the ordinary procedure in the case of a large bond issue. After the promoter banker had bought the preferred stock issue, he organized what was called a syndicate to effect the actual marketing of the stock. The case that was simplest, though probably somewhat exceptional, was that of Cluett Peabody. The banker-promoter telegraphed to a number of bankers throughout the country—who were the usual customers for such preferred stock—the amount of stock which was allotted to them. They were to answer immediately if they accepted his allotment, and to send a check for the amount the same day. Furthermore, they were given a price below which they were not to market the stock. If any one of them had not taken his allotment, he had less chance of being included in the next offering.

A second method of marketing the stock was the one which was commonly used by the largest and most successful promoter-bankers. Such a banker often would merely announce in the market that he had purchased an issue of stock, and customers would be immediately available. These customer-bankers were allowed to subscribe for a definite portion of the issue. In these cases they did not pay for their allotments and carry off their stock. They signed their names as underwriters in a syndicate agreement. Then they returned to their offices and proceeded to sell the stock at a price below which no member of the syndicate could sell. If any banker did not sell his entire allotment, he was nevertheless liable for it at the same price. Thus, his entry into the syndicate agreement amounted to an actual purchase of the stock. In many cases his entry into the syndicate implied immediate remittance to the syndicate-manager (that is, the banker-promoter) of the entire amount of his liability. In some cases this payment was deferred; but in no case was his liability different from

what it would have been if he had made an outright purchase of his allotment.

A third method of marketing the stock was by letters to bankers throughout the country, who were invited to join the syndicate and participate in the manner described above. There was nothing very complicated about these syndicates. Perhaps the fundamental idea in the syndicate marketing was the collective buying and selling in order to keep a standard price below which no participant could sell. It was a more attractive way of buying from the small banker's point of view, because in many cases he did not have to pay for his entire allotment until after he had sold his stock or at least a part of it. However, his liability was the same as in the case of actual purchase.

This syndicate marketing is interesting in that it reveals the way in which the banker-promoter and the other bankers received their remuneration. The promoter-banker received from the owners a bonus of common stock with the purchase of the preferred. When he organized the syndicate of which he was usually a member, he sometimes distributed half or more of the bonus he had received among the participants in the syndicate. He did not reveal the price which he had paid the original owners for the preferred stock nor the amount of the common stock bonus, but it was generally understood that the syndicate was to receive the preferred stock at about the same price that he paid for it and that it was to be marketed with but a point or so of profit. In return for marketing the stock, the participants received common stock bonuses; and the banker-promoter or syndicate-manager also received his remuneration from the common stock he withheld from the syndicate.

The participant in a syndicate sometimes received his remuneration in a different way. He bought preferred stock at 98 which he was told to market at 100, and common stock at 32 which he was told to sell at 40. Assuming that the amounts of preferred and common were equal (a convenient though improbable assumption), he could calculate

a profit of 10 points on the purchase taken as a whole. This remuneration to him seemed no different in kind from the profit he received from buying bonds at 95 and selling them at 100. But, theoretically, there was a difference. The original owners of the preferred stock were supposed to receive almost all the market would give for such stock. What the promoter-bankers received from them and what the syndicate participants were given was a common stock bonus and not a difference in buying and selling price. The actual amount of these bonuses and the remuneration received by the banker-promoters and the customer-bankers is hard to discover. The promoter-bankers told their correspondents very little, and the information on this subjected extended by them was meager.

CHAPTER V

The Principles of Capitalization

The development of industrial corporations which represent the capitalization of goodwill and intangible assets offers some new problems for the accountant and for the economist. It is particularly interesting to the economist to determine in how far bankers and business men take heed of the fundamental laws which govern interest and profit and from which proper principles of capitalization can be deduced.

The accountant defines capital investment as the fixed assets and current assets, which are needed continuously for the operation of a business. He distinguishes carefully the capital which is invested in a business and which is kept there from the money expended by the business for materials, labor, and other items, which go to make up the costs of production. The distinctions which he makes between the capital account (that is, the investment) and the cost account (that is, the costs of production) are not, however, so clearly definable as he seems to think. The accountant insists that investment represents the amount of money actually invested and not any market or other arbitrary evaluation put on the properties.

The accountant adds the sum of the expenditures for any period (namely, the cost of the labor, the cost of the materials, and the overhead costs) and subtracts this sum from the value of the sales in order to determine what he calls profit. As no interest on the investment is included in these expenditures, the accountant's profit includes what the economist regularly defines as interest and profit.[1] The accountant divides his profit by investment in order to determine the return on the investment for the period.

[1] No bond interest is included in cost.

The logical implications of strict accounting reasoning might seem to result in the principle that the capitalization should be identical with the investment. But if the accountant insisted upon a capitalization not in excess of investment his path would not be an easy one. The captains of industry often desire to conceal the actual investment and often feel the necessity of disguising very large returns. Furthermore, in the case of the consolidation of two businesses in which the investment might be the same but the earnings different, it would be obviously unfair to expect the stock holders of the two corporations to accept the same amount of capital stock. Either the differential theory of interest or the differential theory of profit might be adduced in extenuation of a capitalization larger than the original investment. The profits earned by the entrepreneur on different pieces of capital goods may be different, even though the capital invested in the capital goods be the same in amount. Whether these differences represent differences in interest or differences in profits is a technical economic problem which has considerable interest.[2]

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[2] If the preferred stock holders replace the investment of the original owners, the preferred stock dividends may be considered interest. If 7 per cent bonds had been issued instead of preferred stock there would have been little difficulty in determining the economic nature of the return. The high rate of interest, however, seems to suggest the possibility that there is some profit included in this interest, yet, if it be assumed that profit is the entrepreneur's gain and presupposes actual administrative control and that the return for risk is a capitalist's return, the preferred dividend would be considered interest and its size could be explained by the risk involved. The better preferred stocks are marketed in many cases above par, so that the interest paid on investment is not always 7 per cent when the risk is not so great. The earnings on the common stock, then, represent pure profit. This analysis is based on Francis Walker's theory of profit, and practically assumes the inclusion of interest in cost for the determination of pure profit.

The accountant, who includes neither bond interest, preferred dividends, nor estimated interest on investment in cost, seems to assume the differential theory of capital as the basis of his analysis. Different pieces of capital goods are operated with different degrees of efficiency and bring different returns,—and by returns are meant interest plus profit.

The distinction between interest and profit has been less carefully defined by economists than its importance merits. If profit or loss in any particular case can be thought of as the difference between cost

When the proceeds from the sale of the preferred stock are used to replace the investment of the original owners, the preferred stock theoretically should represent approximately the original investment, and the common stock would then represent the entrepreneur's claim on pure profits. If the entrepreneurs hold all the common stock, it makes no difference into how many shares the common stock is divided. If they sell all or a part of it, the problem is not so simple. Those who buy common stock in the stock market are ordinarily not entrepreneurs; although they have legal title to a part of the capital goods and to the product, they have no administrative control. They invest capital in the business, and receive a less certain return because of the claims of the preferred stock holders. Thus, they perform the capitalist's rather than the entrepreneur's function and receive technically the entrepreneur's return or a part of it.

From the point of view of the practical business man, the preferred stock represents assets and the common stock

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and selling price, interest must be included in cost. The accountant includes only actual expenditures in cost, and for the entrepreneur who owns his investment, interest is not an actual expenditure. But when the entrepreneur, i.e., the common stock holders, does not own the investment, the 7 per cent dividend payable to the preferred stockholders, i.e., the capitalists, is clearly an actual expenditure and a cost.

Capital goods, the accountant maintains, do not always yield enough to cover the expenditures of the company and its preferred stock dividends: obviously in such cases there are no profits; there may even be losses. Wage earners do not always earn their wages; yet, the accountant includes in cost the actual amounts paid in wages. Wages must be paid or laborers will not work. If wages are larger than the product produced by the laborers, the profits of the entrepreneur are reduced, but the interest on the capital should certainly not be affected. If capital is not well invested in captal goods, the return imputable to such capital goods is less than the amount which must be allowed for the use of capital. The entrepreneur's profit is, then, reduced by that amount. Capital goods do not earn returns, as is popularly maintained: the entrepreneur with his capital investment, his labor, his land, etc., does the earning. But whether the capital is well invested or poorly invested in capital goods, as capital its return must be considered before profit can be determined. The chief difficulty of the accountant lies in the necessity of estimating the interest on investment to be included in cost. However, when the 7 per cent dividend is actually paid or payable, as in the industrial corporations represented in this study, these dividends should be considered as interest and included in the cost to be deducted from the value of the sales for the determination of profit.

is explained in either two ways, by the intangible values or goodwill and by the earning power in excess of the preferred stock requirements.

It is interesting to consider the opinions of the bankers who have been most active in the flotations of these companies. There seems to be general agreement that no matter what the earnings of a business were at the time of incorporation, the preferred stock had to be covered by the tangible assets. And with but one or two exceptions, this seems to have been the case. The most prominent, perhaps, of the banker-promoters asserted that the value of the tangible assets had to be two or three times as great as the issue of preferred. As a matter of fact, in two-thirds of his companies the preferred was just about equal to the tangible assets, and in the other third the margin above this was very slight. Another banker thought that the amount of preferred stock should have been about one half of the tangible assets at the time of incorporation. All of these estimates were too conservative. The preferred stock was in practically every case covered by the tangible assets, but not by such a margin as these men supposed. The question of common stock issues is a more difficult one. If the owners intended to hold the common stock, the amount of it did not concern them particularly. If the common stock was to be marketed immediately after incorporation, the owners would in all probability have desired as large an issue as possible. Certain bankers estimated that the earnings on the common stock after the payment of the preferred dividends were, on the average, five or six per cent. As a matter of fact, the average was considerably higher. The reason for this will be considered later.

The opinions of the bankers are interesting in that they show that there was no one principle of capitalization which explained both preferred and common stock and that a different theory explained the preferred stock from that which explained the common. The preferred stock was limited by the tangible assets; the common stock had its

justification in the earning power. True, the preferred dividends had to be covered by the earnings: so seldom, however, did an issue of preferred stock appear, the dividends of which were not easily covered by the profits, that the bankers seldom thought of the preferred stock in its relation to the earnings. Sometimes a prospectus would announce the ratio of the earnings to the preferred dividend obligations, but this was clearly not a significant feature and was adduced more in the nature of additional evidence for convincing the investor of the safety of the preferred. An issue of preferred stock was usually thought of as an issue of obligations; important similarities to bonds will be indicated in another place. As much as the bankers say about the intangible values or good will that were behind the common stock, they realized that it was the earning power that was the real justification. The fact that the corporation earned more or was expected to earn more than enough to pay the dividends on the preferred stock gave value to the common stock.

Evidently there are two things which are of importance in the capitalization of these industrials: first, the ratio of tangible assets to the preferred stock at the time of incorporation; second, the earnings on the common stock.

The amount of preferred stock issued at the time of incorporation is shown in the first column of the table on page 44. In the second column is the ratio of the tangible assets to the preferred stock. By tangible assets are meant capital stock and surplus with goodwill deducted, as they appeared on the first balance sheet. This amounted to the same thing as the tangible assets with the bonds, notes, and current liabilities deducted. Very often, as it was explained earlier, a part of the proceeds from the sale of the preferred stock was returned to the corporation for working capital. This addition would naturally be included in the tangible assets. Furthermore, when the outstanding liabilities of the business were liquidated by the sale of the preferred stock, the tangible assets appeared that much greater because of the decrease in the amount deducted for

liabilities. If the preferred stock was equal to the tangible assets, this ratio was unity. If the preferred stock was one half or one third of the tangible assets, this ratio was two or three. Thus, the larger this ratio, the more conservative was the issue of preferred.

In the third column is the amount of common stock issued. In the fourth column are the earnings (after the deduction of the preferred dividends) on the common stock. Although the companies were just starting their corporate lives, there was naturally a record of yearly earnings for the private businesses which preceded them. If these earnings had showed any regular increases or decreases, the probable earnings for the first year of the corporation might have been estimated. As a matter of fact, these pre-incorporation profits were in most every case so irregular and fluctuating that some more arbitrary method of calculating the probable earnings has had to be adopted. The earnings of the three, four, or five years preceding incorporation were usually given when a flotation was advertised. An average of these three, four, or five years has been calculated. As most of these businesses increased their earnings from year to year, this average seemed in many cases too low an estimate of the corporation's probable success. Therefore, it seemed best to take an average of this average and of the profits for the last year. The figures in column 4 have been obtained in this way. This method was desirable because it gave a larger prominence to the profits of the year immediately preceding incorporation. In most cases, when a prospectus gave profits, it meant profits after the deduction of interest charges. When a business paid its debts by the sale of the preferred stock, its profits after incorporation showed an increase, other things being equal, merely because the interest charges were decreased or done away with and because the preferred dividends were not deducted from net profits. Furthermore, the new working capital would in all probability have increased future earnings. However, a business that was incorporated merely to enable the owners to withdraw their capital could

anticipate as great an increase in profits as the other types because it was most likely a better business in that it had been built up slowly and had no large debts, and no need of new working capital.

The table on the following pages shows the capitalization of forty-six industrial corporations.[3]

When the large number of private businesses that were incorporated is considered, this material may seem meager. Many private businesses were incorporated, however, because of the legal disadvantages inherent in a partnership. Many of them were closed corporations, that is, they had no securities in the open market. Some merely issued common stock and were capitalized in a different, and in a less elaborate, way than those discussed here. Some were quoted on the smaller exchanges and were not so well known; the necessary data concerning these companies was usually not available. Of the forty-six corporations given, twenty-four were listed on the New York Stock Exchange and seven were traded in on the Curb; practically all of the others were listed on the smaller exchanges. Many of the industrials quoted on the exchanges, and even a number of those which had preferred stock, were very different from the type dealt with here. The trusts and the combinations did not ordinarily issue stock only for sale in the market. The stock of these companies was usually issued in part to the different owners in payment for the businesses which they surrendered to the trust or to the combination.

Of the industrials in the table, five produced rubber goods and rubber tires.[4] There were four automobile companies.[4] There were six which made agricultural implements.[4] There were four chains of five and ten cent stores, and two department stores.[4] There was one canning company and one can making company, and three which manufactured and sold articles of food consumption. There were twelve which produced or sold articles of clothing.

[3] From original prospectuses issued by the promoter-bankers and from Poor's and Moody's Manuals of Industrials.

[4] See appendices i, ii, iii, and iv.

Name of Corporation	Preferred Stock	Ratio of Tangible Assets to Preferred Stocks	Common Stock	Probable Per Cent Earned on the Common Stock (After Deducting Preferred Dividends from Net Profit)
B. F. Goodrich.....	$30,000,000	1.13	$60,000,000	8.3
Goodyear.........	5,000,000	2.00	5,000,000	22.8
Fisk..............	1st 3,000,000	1.00	8,000,000	5.2
	2d 2,000,000			
Kelly-Springfield...	1st 3,758,000	1.24	4,000,000	23.5
	2d 907,000			
Ajax-Grieb........	330,000	3.71	450,000	34.0
Studebaker........	13,500,000	1.77	30,000,000	4.5
Willys-Overland....	5,000,000	2.16	20,000,000	12.5
Maxwell..........	1st 13,000,000		13,000,000	0.0
	2d 11,000,000	1.04		
Hupp............	1,500,000	1.73	5,000,000	9.0
Emerson-Brantingham............	12,000,000	1.45	10,000,000	7.0
Deere............	37,800,000	1.18	18,400,000	7.5
Case (J. I.)........	12,000,000	1.66	8,000,000	5.7
Moline Plow.......	1st 7,500,000		9,000,000	
	2d 1,500,000	2.04	9,000,000	11.0
M. Rumely........	8,000,000	2.32	9,000,000	6.3
Hart-Parr.........	750,000	2.44	1,000,000	24.5
F. W. Woolworth...	15,000,000	1.00	50,000,000	6.8
S. S. Kresge........	2,000,000	1.23	1,000,000	3.3
S. H. Kress........	4,000,000	1.10	12,000,000	6.6
McCrory..........	1,250,000	1.60	5,000,000	4.3
May Dept. Stores..	5,000,000	1.00	15,000,000	5.9
Kaufman Dept. Stores..........	2,500,000	1.00	7,500,000	8.0
Hart Schaffner & Marx...........	5,000,000	1.00	15,000,000	3.9
Sonneborn.........	1st 750,000		2,500,000	
	2d 1,000,000	1.14		6.7
A. B. Kirschbaum..	1,350,000	1.48	2,650,000	5.0
Frisbie Stansfield...	1,300,000	1.15	1,500,000	3.0
Barnhart Bros. & Spindler........	1st 1,250,000		1,000,000	
	2d 750,000	1.00		1.3
Pierce, Butler & Pierce..........	1st 700,000	1.17	800,000	4.3
	2d 150,000			
International Shoe .	8,250,000	1.00	12,750,000	6.9
McElwain Shoe....	1st 2,500,000		1,500,000	
	2d 1,000,000	1.43		30.0
Brown Shoe.......	4,000,000	2.50	6,000,000	5.0
Julius Kayser......	1st 3,000,000		6,000,000	9.3
	2d 695,000	1.26		
Cluett Peabody....	8,000,000	1.00	18,000,000	8.2
Manhattan Shirt...	3,000,000	1.00	5,000,000	5.6

Name of Corporation	Preferred Stock		Ratio of Tangible Assets to Preferred Stocks	Common Stock	Probable Per Cent Earned on the Common Stock (After Deducting Preferred Dividends from Net Profits)
Acme Tea.........	1st	2,750,000		3,500,000	
	2d	500,000	1.00		12.1
Jewel Tea.........		4,000,000	.99	12,000,000	11.1
Loose-Wiles.......	1st	5,000,000		8,000,000	
	2d	2,000,000	1.00		00.0
Continental Can...		5,500,000		8,000,000	
		5,500,000	1.00		5.0
Armsby Co. of N. Y.		500,000	2.00	420,000	26.9
Sears Roebuck.....		10,000,000	1.00	30,000,000	5.8
National Cloak & Suit............		5,000,000	1.00	12,000,000	8.0
Griffin Wheel......		6,000,000	1.41	9,300,000	12.9
Kelsey Wheel......		3,000,000	1.00	10,000,000	7.5
Pettibone Mulliken.	1st	2,250,000		7,000,000	
	2d	750,000	.82		5.6
Burns Bros........		2,000,000	1.25	5,500,000	6.3
Owens Bottle Machine...........		7,000,000	1.92	9,000,000	27.5
Underwood Typewriter..........		5,000,000	1.00	8,500,000	4.5

There were two mail-order houses, two wheel manufacturing companies, and four miscellaneous companies.

The ratios of the tangible assets to the preferred issues furnish the basis for some reasonably satisfactory generalizations. The average of the figures in the second column is about 1.39. In other words, the amount of preferred stock issued by the companies, studied in the table, was roughly seven-tenths of the tangible assets. In more than one-third of the cases recorded the preferred stock was about equal to the tangible assets. The fact that the average is as high as it is can be explained by several causes; first, earlier in the history of these industrials when preferred stock of this kind was not so well known, some of the issues were more conservative; second, the smaller companies, which were comparatively less stable, had to be more careful in their financing; third, industrials like the agricultural implement companies, the earnings of which seemed likely to be subject to great fluctuations, were wisely

somewhat conservative in their preferred issues. All these factors tended to make the average for this table higher than the figure which represented the usual practice, that is, the practice which obtained in the largest number of flotations.

The average of the percentages earned on the common stock of these companies was 9.7; yet in most cases the percentage lies somewhere between 5 per cent and 7 per cent. Here, too, the usual percentage was considerably lower than the average for this table. This disparity is due to the large percentages earned by the common stocks of the smaller industrials. All those companies which earned more than twenty per cent on their common stock, with the exception of Goodyear, were small and not so well known, for example, Armsby, Owens Bottle Machine, Kelly-Springfield Tires, Ajax Rubber & Tire, Hart-Parr, and McElwain Shoe. The per cent earned by the common stock of the better known industrials is surprisingly low. Sears Roebuck, Underwood Typewriter, Continental Can, Studebaker, Brown Shoe, F. W. Woolworth, Manhattan Shirt, and Hart, Schaffner and Marx, started with common stock issues which were very large when compared to their past earnings. The first six of the eight industrials mentioned were the work of the bankers, Goldman, Sachs & Co. The common stocks bought out by these bankers are usually listed and traded in on the New York Stock Exchange immediately after the incorporation. This would seem to indicate that some of the most important of the common stock issues—those which were released by the owners and sold to the public—have been the least conservatively capitalized. True, these companies had been enormously successful as private businesses and anticipated futures which seemed to justify large issues of common stock.

There is one important question as to the difference between those common stocks which were held by the owners and those which were sold in the market. When a private business was incorporated or when a closed corpora-

tion was reincorporated so that the preferred stock could be sold, the control of the common stock, theoretically, was held by the owners.[5] The common stock with its voting power was the means by which they controlled the business. Apparently one, of the most useful arguments employed by the bankers who were trying to persuade a large merchant to incorporate was that by so doing the intangible values, or goodwill, and the surplus earning power could, thus, be capitalized and sold. If at the death of one of the two partners, who owned a business with tangible assets values at $2,000,000, but with yearly earnings of about $400,000, and if the widow of the deceased were paid off by the surviving partner with $1,000,000, she could count on an income of $60,000 at best, whereas before her husband's death their income had been $200,000. If these partners had been incorporated they could have sold $2,000,000 worth of preferred stock; each one might have withdrawn his million and, yet, with $4,000,000 worth of common stock they would have controlled the business and its surplus earnings. At the death of one of the partners the widow would receive $2,000,000 worth of common stock besides the $1,000,000 withdrawn by her husband when he sold the preferred. The banker explained further that there was a method by which this widow could be put in a position to dispose of her common stock if at any time she so desired. All that the owner had to do was to give the banker a large enough slice of the common issue so that he could put it on the market and, thus, advertise it. Then, at any time, the large holder of the common stock could unload. However, the careful banker tried to keep the owner from selling his common until he reached the age of retirement. It was to the interest of all that the men who had been responsible for the success of the business should hold the reins as long as possible.

There is a well-marked difference between those common stock issues which were to be held by the owners and those

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[5] Jones Bros. Tea Company sold the common stock and held the preferred stock, but this was exceptional.

which were to be sold in the market. Obviously it made very little difference to the owner whether the common stock was divided into a million or into four million parts, provided he held it all. Thus, companies like Kelley-Springfield (the early issue), Ajax-Grieb, Hart-Parr, Mc-Elwain Shoe, Armsby Co., and Owens Bottle Machine earned between twenty and thirty per cent on the common stock. Even where common stock was marketed, small companies like those mentioned were obliged to offer especial inducements because of the advantages of larger, more stable, and better advertised companies. The reason why the larger and the better known industrials showed such small earnings on the common at the time of incorporation is explained paradoxically enough by the difficulty of selling industrial common stocks at a high price. It was difficult to market at par what most people usually considered water. The larger the amount, the lower was the price that could be put upon it. But it was not an immediate market which was anticipated. The owners hoped for large earnings in the future and they desired to be in a position to sell the rights to these earnings—in the form of common stock—to the best advantage.

There are corporations represented in the table that earned nothing on their common stock. The amount necessary to pay the preferred dividends completely covered the probable earnings. Two such companies were the Maxwell Motor Co. and the Loose Wiles Biscuit Co. A very interesting fact is that both of these companies had second preferred stock. A natural deduction would be that the owners of those compaines, which earned nothing on the common stock, took the second preferred stock so as to assure themselves a dividend. There are twelve companies in the table which have second preferred stock: two show no earnings on the common stock; one shows only 1.3 per cent; and four show very low percentages. However, three or four show earnings considerably above the average. It is worthy of mention that five of the twelve companies noted were sponsored by William Salomon & Co., a firm which seems partial to second preferred stocks.

Some important facts emerge when these industrials are divided into classes according to the kinds of business which they transacted. It is found that the corporations which had the highest ratios of tangible assets to the respective preferred issues are the agricultural implement companies, the rubber and tire companies, and the automobile companies. The average ratio for the agricultural implement companies was 1.85. When compared with the general average 1.39, this seems remarkably high. There are two possible explanations for the high ratio in the case of the agricultural implement companies. The agricultural implement stocks were brought out in 1911 and 1912 when these new industrials were just coming into prominence. Furthermore, this type of business seemed obliged to undergo great fluctuations in profits from year to year.[6] In all but one of these companies, however, the amount authorized was considerably higher than the amount issued. If the authorized preferred stock had been used to calculate this ratio it would have averaged 1.21 instead of 1.85. Another explanation of the high ratios applicable to all three industries is based on the fact that they all had large plants and expensive machinery.[7] This was not true of the department stores and the other manufacturing businesses.[8] The ratio of the preferred stock to the earnings may have been very much the same, but in these three kinds of companies the greater value of the tangible assets seems to explain the high ratios shown.

Studebaker was put out with a very conservative preferred issue. The ratio in this case was 1.77. After the explanations of the high ratios in the table, it is interesting to consider the facts in the case of Studebaker. When Studebaker was incorporated, the automobile business was not as highly developed as it is today. The bankers did not know at that time whether the automobile was merely a fad or whether the business was to develop stability. For this reason they were probably cautious. If the business

[6] See appendix i.
[7] See appendices i, ii, iii.
[8] See appendix iv.

had failed to develop, the real estate, buildings, machinery, and equipment, amounting to almost $10,000,000, would have been worth very little. The preferred issued, therefore, was covered by the inventories, which amounted to more than $14,500,000, and the amount authorized was very little more.

Generally considered, the earnings on the common stock of the agricultural implement companies and of the rubber and tire companies were high, whereas the earnings for the automobile companies were below the average. Inasmuch as the preferred issues of these companies were small when compared to the tangible assets, it is natural to ask whether the issues of common were correspondingly small when compared to the earnings. In other words, the possible relation of the figures in column 2 with those in column 4 is suggested. Was a conservatively issued preferred stock likely to be accompanied by a conservative issue of common? It is natural that there should be a certain relation between the figures in the second and fourth columns inasmuch as in both cases they are affected by the amount of preferred stock. If this amount is small not only will the ratio of tangible assets to the preferred be comparatively high, but the earnings on the common will be larger because of the smaller deduction necessary for the preferred dividends. An estimate of this relation in mathematical terms seems to show that the ratios in the two columns are not so closely related as one might expect. Furthermore, it is evident that there is a greater dispersion for the percentages in the fourth column than for the ratios in the second. Preferred stock issues in relation to tangible assets varied much less than common stock issues in their relations to earning power.

The principles deducible from the data given in the table, important as they are, do not furnish material sufficient to construct any complete theory of capitalization. They are valuable as evidence and as proof of a theory which anyone, who is familiar with these industrials, might have evolved. The amount of preferred stock issued was, to

some extent, dependent upon the particular reason for the flotation. If the owners wanted to withdraw a certain sum and felt that it was best to pay off a part of the indebtedness at the same time, the size of the preferred issue was influenced by these desires. True, the preferred issued was seldom more than the tangible assets; yet, how much less it was, was determined by the purposes of the owners. The period in which the stock was floated, the condition of the market at the time, and other factors determined the capitalization rather than any abstract principle. When a business had large tangible assets or when there was some particular need for caution, the bankers probably insisted upon an abnormally conservative ratio of tangible assets to preferred stock. In short, the size of a preferred stock issue was determined chiefly by the amount of money which the managers of the flotation could obtain with safety from the public at the time. The reason why in such a great number of cases the preferred issue was equal or almost equal to the tangible assets is explained by the desire of the owners to obtain as much money as possible. When there was an abnormally small amount of preferred, the issue seems to have been merely a more convenient method of obtaining money than that of borrowing from the banks or selling bonds. The amount of preferred stock may at times have had less direct relation to the value of the assets or to the earning power of a business than it had to the specific needs which prompted the incorporation.

Some of these companies showed earning on the common stock (see page 44, column 4,) as low as nothing and others as high as thirty per cent. Those common stocks which showed no earnings represented mere anticipations of future profits. Those which earned abnormally high percentages were usually held closely, and were not sold in the market. They were associated with small preferred issues; these flotations were, as it was explained before, merely methods of borrowing a small sum from the public in preference to getting it from the banks. If the common stock was to be kept by the owners, it made little difference to them into

how few shares it was divided. If it was to be sold, the amount was determined by the conditions of the market. It was divided so that the shares could be sold for a low enough price and so that the aggregate would net for the sellers the amount that they desired. Somewhere between five and six per cent was the usual amount earned on the common, because stock capitalized in this way was most profitably marketed. The relation between the figures in the second and fourth columns shows that there is no reason to believe that there was any definite theory of capitalization which generally influenced the incorporators.

CHAPTER VI

The Seven Per Cent Preferred Stocks and their Provisions

The kinds of securities which were created for these companies constitute an important part of this study because these businesses were incorporated in most cases merely to sell stock and because the stock sold was different in certain respects from any that had been issued before. There were three kinds of securities which might have been issued—bonds, preferred stocks, and common stocks. The wide-spread use of preferred stocks instead of bonds is a matter of some interest. Did these companies issue preferred stocks rather than bonds because bonds represented mortgages on the property, or because bonds called for a regular interest even in times of depression? Were investors satisfied with preferred stocks because they realized that a business of this kind could furnish no real security for a mortgage? These are questions which cannot be answered until after the development of preferred stock has been traced and the actual provisions of the modern preferred stocks have been analyzed.

In England during the seventeenth century there was the gradual emergence in the joint-stock company of a division of the whole capital into different classes with special rights. In the case of the new East India company, the stock as such was divided into separate classes, each of which had distinct rights, the original stock being entitled to eight per cent, paid by the government, and to certain contingent advantages, while the additional stock was to receive the profits made in trading.[1] Out of this differentiation of stock in England there developed the debentures which were like our bonds except that they embodied no

[1] Scott, vol. i, p. 364.

mortgage feature. In "The Minutes of Evidence taken before the Select Committee on the limited liability Acts," 1867, there was an interesting discussion of the use and the rights of debentures in limited liability companies. It was stated there that debentures had been issued to obtain new capital when the company did not want to make calls on the original share holders. The rights of the debenture holder with respect to the assets, the earnings, and the creditors of the company, as there outlined, were similar in many respect to those of the preferred share holder.

There were two specialized uses to which preferred stock was put in the earlier development of corporation finance in the United States. When the corporate form was used as a financial instrument for combining individual businesses, preferred stock was a common feature in the financial plan. The owners who surrendered their businesses to the corporation, received in many cases a certain percentage of preferred stock as well as common stock. This preferred stock had a priority over the common stock mainly with respect to earnings. It was very much like the English debenture and merely represented a differentiation in capital stock. The other use of preferred stock was one common in railroad finance. A writer in 1897 stated that the majority of preference shares in the hands of the public at that time had been issued by the railways as evidences of debt which the exigencies of the time required should be deferred,—perhaps some peculiar obligation not then easily paid; but more frequently, such preferred shares had been given to bond holders who were compelled by the insolvency of the company to yield something of the principal and interest of their debt.[2] In the reorganization of the Chesapeake and Ohio Railway in 1888 the bond holders consented to readjust their claims without foreclosure, and took as part payment for the old bonds a certain percentage of first preferred stock. Eleven years earlier in the case of the Lake Superior and Mississippi Railroad which was

[2] T. L. Greene, Corporation Finance.

sold under foreclosure to the holders of its first mortgage bonds, these bonds were exchanged for preferred shares at the rate of $1200 of such shares for each bond of $1000.

The new seven per cent preferred stocks differed materially from both of these. They had both bond features and common stock features. Although the type of seven per cent cumulative preferred stocks employed by the new companies was not fully developed until the rise of these industrial corporations in the present century, there had been some very considerable issues of industrial preferred stocks before that time. In 1890 the H. B. Claflin Company was formed in New York City to take over the jobbing business of H. B. Claflin and Co. The new company had a capital of $9,000,000 divided into first preferred stock, bearing cumulative dividends of five per cent, second preferred stock, bearing cumulative dividends of six per cent, and common shares covering nearly one half of the capitalization. But this preferred stock of H. B. Claflin and the other preferred stocks which were issued before the rise of the new industrials were merely stocks with a certain priority and fixed dividend. The safety features exemplified in the new seven per cent preferred stocks were not present.[3] There was no possibility of standardization in the preferred stocks of the older period because they varied in rôle with every incorporation.[4] They had an indefinite position somewhere between bonds and stocks. They paid dividends anywhere from four per cent to eight per cent and higher; sometimes they were cumulative and sometimes they were not.

The new industrial preferred stocks constituted a definite class of financial instruments; and although there were differences in the provisions of different issues, these were usually of minor importance. Practically all of the stocks paid seven per cent, and all were cumulative. When Spicer was put out with an eight per cent cumulative dividend in 1916, the bankers probably offered the extra

[3] One of the earliest mutual insurance companies had a temporary capitalization of seven per cent preferred stock.

[4] Except perhaps in their use in railroad reorganizations.

one per cent as a special inducement at a time when the market was teeming with so-called speculative issues. The necessity of the cumulative feature was evident; a preferred stock would have been little better than a common stock if the company could have deferred the dividend with impunity. The regular per cent paid on the preferred stock and the cumulative feature were similar in nature to bond provisions. Most of the rights of the preferred stock holders, as set forth in the articles of incorporation of these industrials were directly or indirectly provisions for safety, and as such made preferred stocks still more like bonds. These provisions were engrafted on what would have been ordinary shares of capital stock. Consequently, the differences between bonds and stocks may be used conveniently as a basis of classification of these provisions.

The bond is ordinarily a charge on a specific piece of property,—naturally the property should be as valuable, if not more so, than the amount of the bond issue. Practically every issue of preferred stock in the new industrials was covered by the tangible assets of the company, even where there was no specific mention of this limitation in the certificate of incorporation. What was embodied in practically every certificate of incorporation was the requirement that the consent of three-fourths of the preferred stock holders should be given to any increase of the authorized preferred issue or to any mortgage, which would naturally take precedence over the preferred stock. These provisions as they appear in the Certificate of Incorporation of the Continental Can Co. are typical:

(4) The amount of preferred stock shall not be increased nor shall any stock having any preference or priority over said preferred stock be issued unless such increase or such issue shall have been previously authorized by the consent of at least three-fourths in interest of the then issued and outstanding stock of the Company of each class (both preferred and common) given separately, in person or by proxy, at a meeting specially called for that purpose. . . . (9) No mortgage, lien or encumbrance of any kind upon any part of the real or personal property, assets, effects, undertaking or goodwill of the Company, shall be created or be valid or effective unless the same shall have been previously authorized by the consent of the holders of at least three-fourths in interest of each class of outstanding stock of the Company (both Preferred and Common) given separately in person

or by proxy either in writing or at an annual meeting or at a special meeting called for that purpose; but this prohibition shall not be deemed or construed to apply to, nor shall it operate to prevent, the giving of purchase money mortgages, or other purchase money liens on property to be hereafter acquired by the Company, or the acquisition of property subject to mortgages, liens and encumbrances thereon then existing, nor to the pledging by the Company as security for loans made to it in the regular and current conduct of its business or notes or accounts receivable or other liquid assets or of any stocks, bonds, or other securities owned by it.

If the tangible assets did not depreciate in value, the preferred issues would always be covered by specific property. Some companies not only restricted any increase in the issue of preferred, but attempted to make sure that the preferred issue should bear a certain relation to the tangible assets. They forbade any dividends on the common stock unless the preferred bore a certain definite relation to the assets. In the Certificate of Incorporation of The Brown Shoe Company, it was stated:

In no event shall any dividend whatsoever be paid or declared on the Common Stock, unless the net quick assets of the Company and of its subsidiary corporations as disclosed by the then last statement or report of the Company, certified by certified public accountants of good standing, shall have been at least eighty per cent (80 %) of the total amount of preferred stock then outstanding, and the total amount of the net tangible assets of the company shall have exceeded the amount of preferred stock by one million dollars.

In the Fisk Tire Company, no dividends could be declared on the common stock unless the net quick assets of the Company were at least equal to one hundred and twenty-five per cent of the par value of the first preferred stock of the Company outstanding. In the Willys-Overland Company of 1912, no dividends could be declared on the common stock unless the net quick assets were equal to one hundred and twenty-five per cent of the outstanding preferred; in the Willys Company of 1916 the net quick assets were to be one hundred and ten per cent of the preferred before any dividends over six per cent could be declared on the common. In the M. Rumely Company, the net quick assets were to exceed the preferred stock, and in the Loose Wiles Biscuit Company, the net quick assets were to be equal to one half of the preferred stock

before any dividends on the common were allowed. The purpose of these provisions seems to have been the desire to assure the preferred stock holder of the company's ability to pay him the par of his investment and even a premium added thereto in case of liquidation. In those cases where the net quick assets were to be sufficient to cover the preferred issue, he was assured of a speedy payment of his claims.

In all these provisions, however, there was one feature which complicates the matter somewhat. The restriction upon the payment of dividends on the common stock was not only intended to assure the preferred stock holder of the mortgage value of his investment but also to make certain the continuance of his dividends. The preferred issue was limited so that there would not be too many claimants for the funds available for dividends; and the declaration of dividends on the common stock was also limited so that there would be a large enough fund available for preferred dividends to be paid in the future. In the majority of cases the provisions of the certificates of incorporation were intended to dispel the fear which might otherwise have attacked the preferred investor,—the fear that the company would distribute more to the common stock holders than was consistent with safety.

Certain other provisions found in the cases of these preferred stocks look also primarily to the protection of the dividends of the preferred stockholder. In the Underwood Typewriter Company and in the May Department Stores Company, salaries were limited to $60,000 a year. In the first case this amount could be increased if the net earnings passed the million mark; but even then only to the extent of six per cent of the earnings. In the May Department Stores Company this limitation was to last for three years; thereafter, the amount to be paid in salaries could be increased by a sum equal to one-half of one per cent of the sales. In the Henry Sonneborn Company, too, such a limitation on the amount available for salaries was incorporated in the provisions intended to protect the

dividends of the preferred stock holders. In the Julius Kayser Company there could be no expenditure (in cash, stock, bonds, debentures, or otherwise) in the aggregate exceeding $200,000 for the purchase of additional mills or properties, or in otherwise adding to the corporations existing fixed capital assets, unless at the time of the authorization of such expenditure the net quick assets of the corporation were equal in amount to the par value of the first preferred stock outstanding, plus the amount of such expenditures.[5] In the Brown Shoe Company the issue of the full amount of authorized preferred stock was contingent upon the earnings being twice the preferred dividends. In the Owens Glass Bottle Machine Co. the vote of the preferred stock holders was not necessary in order to increase the issue; but no new preferred stock could be issued unless the earnings for the last year or the average earnings for three years were equal to two and one half times the dividends on the preferred stock, including that which was to be issued, and unless the outstanding preferred issue plus the new preferred issue was less than seventy-five per cent of the net assets of the company including the assets to be acquired from the issuance of the additional preferred stock.

Whether or not the mortgage feature of a bond is valuable because it pledges a specific property, it certainly constitutes a valuable weapon in the hands of the bond holders, who have a contingent right of foreclosure. The preferred stock holder was given a somewhat similar weapon. With few exceptions the preferred stock holder, like the bond holder, had no vote in the affairs of the company.[6] However, if there was any default in the payment of preferred dividends, the preferred stock holders were given voting power. In some of the earlier industrials, for example, Underwood Typewriter, May Department Stores, Studebaker, the preferred stock holders were to assume control after two quarterly defaults; in the majority of cases four quarterly

[5] Otherwise two-thirds of the preferred votes had to consent to such expenditure.

[6] Exceptions were Loose Wiles, Goodyear, Pettibone Mulliken.

defaults were necessary, although in Rumely only one default, and in Armsby as many as eight defaults were to precede the assumption of control. In some cases the preferred stock holders were to vote as a class, with the common stock holders voting as a class, after the specified number of defaults. In the great majority of cases, however, the preferred stock holders were to take over the entire control of the company, in case of its inability to pay their dividends.

It seems reasonably clear that, except in those cases where the contrary is distinctly stated, the directors have the right to sell the assets of the corporation without the consent of the stock holders. In some cases, this right was modified. In the Underwood Typewriter Company the preferred stock holders had the right to assume control after two consecutive defaults in quarterly dividends; but their right of disposal of the property was limited by a provision which made it impossible for the directors of the corporation to sell any part of the assets without the consent of three-fourths of all outstanding capital stock of the company,—each class of stock voting separately. Thus, the common stock holders could have prevented the dissolution of the company. Furthermore, in those cases where the default in a certain number of quarterly dividends gave the preferred stock holders only a joint control with the common, the assent of the common stock was necessary before any disposal of the assets was possible. But in the great number of instances the preferred stock holders were to assume the entire control after the specified defaults, and would thus be in a position to effect a sale of the company through the directors whom they elected, unless the directors were restricted by some provision of the certificate of incorporation.

It is probable that the common stock holders in most cases would have voted against dissolution, since the preferred stock holders were entitled to the par value of their holdings and in most cases a premium, before any other distribution of assets to the common stock holders was

possible. The practice with respect to the payment of premiums was of two kinds. In the case of Emerson-Brantingham, upon dissolution, voluntary or involuntary, the holders of the preferred were entitled to be paid in full $115 per share and unpaid accrued cumulative dividends thereon, before anything was paid to the holders of the common stock. However, the more common provision was that which is exemplified in the following quotation from the Pettibone-Mulliken certificate: "In the event of any liquidation or dissolution or winding up of the Corporation the holders of record of the First Preferred Stock shall be entitled to be paid in full the par amount of their shares, and, in the event of any voluntary liquidation dissolution or winding up caused otherwise than by bankruptcy or insolvency, a further amount equal to fifteen per cent of such par amount, and all accrued dividends." The theory was that in case of difficulty and involuntary dissolution the preferred stock holder was entitled to the par value of his investment; but in a voluntary dissolution which might be the result of a desire on the part of the common stock holders to get rid of the preferred stock, the preferred stock holders were to be paid a premium. This premium varied from ten to twenty-five per cent of the par value, and coincided with the redemption price offered by the company when it called in the preferred for the sinking fund.

Perhaps the most characteristic of the bond features which was engrafted on the preferred stock was the sinking fund provision. The bond is a debt of a company. Except in the case of certain special classes of securities, for example, railroad bonds, the investor had usually demanded that provision should be made in the loan contract for the extinction of the debt from earnings. Either a certain amount of the bonded debt is paid each year until all of it is wiped out, or provision is made for the accumulation of a fund which eventually will retire the entire issue. Both of these methods of amortization were used in the different preferred issues. Practically all of the companies here considered were required to provide a specified sum

of money each year to be used in the retirement of the preferred stock.[7] In those cases in which immediate redemption was required, it was provided that if the stock could not be purchased in the market below a certain price, known as the redemption price, shares were to be called in. Usually a certain proportion of each preferred share holder's holdings was to be called for redemption. In very few cases was redemption by lot provided for. In Rumely Co., Manhattan Shirt Co., Armsby Co., Continental Can Co., National Cloak and Suit Co., and Jewel Tea Co., the method to be used in calling for redemption was left to the judgment of the directors.[8]

One of the simplest serial redemption provisions was that of the B. F. Goodrich Company.

> The Company shall annually, out of the surplus profits of the Company, if sufficient, after all cumulated and defaulted dividends (if any) upon said preferred stock shall have been paid, or set apart, acquire by redemption or purchase thereof in such manner as the Board of Directors may determine from time to time, but at not to exceed $125 per share plus accrued and unpaid dividends thereon, at least three per cent (3 %) of the largest amount in par value of said preferred stock that shall have been at any one time issued and outstanding. If less than the said amount of preferred stock shall be acquired by the Company in any year the deficiency (before any dividend on the common stock shall be paid or set apart) shall be made good out of the surplus profits in subsequent years.

Three per cent of the preferred issue was to be withdrawn each year until after thirty-four years the preferred stock was all to be wiped out.

In a few companies, a specified sum of money was to be set aside each year, but the use of this money or of all of it for the immediate purchase and retirement of preferred stock was not imperative. For example, in the certificate of incorporation of Julius Kayser and Co., it was provided that the company was to put aside $200,000 each year, and to spend $150,000 of the fund in the redemption of preferred stock. In the Brown Shoe Company and in

[7] The only exceptions were some of the early industrials, e.g., the United Cigar Manufacturers.

[8] The Henry Sonneborn Co., when it was necessary to wipe out a certain amount of preferred, asked the preferred stock holders to state the price which they would take for their holdings.

Cluett-Peabody either $2\frac{1}{2}$ per cent of the preferred issue was to be retired annually, or a sum of money sufficient to redeem such a percentage of the issue was to be put aside each year until after four years when, the aggregate of these sums being large enough to purchase 10 per cent of the issue, it was to be applied immediately to the purchase and retirement of preferred stock. Whether the compulsory retirement of preferred stock each year or the accumulation of a sinking fund—which was in extreme cases available for preferred dividends and, perhaps, even for actual business purposes in many industrials—was preferable from the preferred stock holder's point of view may be questioned. The compulsory retirement of the preferred stock was the usual method.

There are many evidences in these provisions that the preferred stock was looked upon as a form of indebtedness which it was the duty of the company to discharge as rapidly as possible especially if times were good. In practically every company no dividend could be paid on the common until the "Special Surplus Account" or the "Preferred Stock Sinking Fund," as it was variously called, had been provided for. Furthermore, no dividend over 4 per cent on the common was allowed in Underwood, May, Kayser, Studebaker, Woolworth, etc., unless there had been accumulated a considerable reserve over and above the special surplus account. In the case of Emerson-Brantingham, Willys-Overland, Jewel Tea, and others, somewhat higher dividends (6 and 7 per cent) were allowed; but before any dividends beyond this rate could be paid an additional surplus was necessary. In some of the companies put out by William Salomon & Co. there was one very interesting type of provision. In these companies, if any dividend above a certain per cent was declared, the amount of the installment paid to the sinking fund had to be increased. In the Pettibone, Mulliken Company, if any dividends in excess of six per cent were paid upon the common stock, then the payment to the first preferred stock sinking fund next payable after the declaration of

such dividend was to be increased by a sum equal to the amount of dividends in excess of six per cent so paid upon the common stock. Emerson-Brantingham and Rumely had similar provisions. If the sinking funds of the new industrials were not kept up in times of depression the obligation was in most cases cumulative and the deficit had to be made up in subsequent years before any dividends on the common stock could be paid. In some cases these special surplus accounts were even available for preferred dividends in times of emergency; but it was always provided that there should be subsequent compensation for such withdrawals.

The review of the preferred stock provisions, which has been given, is sufficient evidence of the fact that the investment bankers, the lawyers, and the owners looked upon the position of the preferred stock holder as highly analogous to that of a bond holder. But there were important differences between the bond and the preferred stock. A summary recapitulation of the likenesses and of the dissimilarities of the two classes of instruments immediately leads to important conclusions. First, the size of preferred issues in some cases was restricted, as in bond issues by the tangible assets of the company. But the desire to limit the amount of preferred stock so as to be able to pay the preferred dividends was as strong a factor in this provision as the desire to keep the size of the issue within the value of the property of the corporation. Second, the requirement that the consent of three-fourths of the preferred stock holders should be necessary to any mortgage suggests the first mortgage feature of the bond; but the requirement of such consent to any increase of preferred stock seems to show that what the preferred stock holder was as much interested in was the fact that he had a prior lien on earnings. Third, the preferred stock holder like the bond holder had no voting power in the ordinary affairs of the company. However, if he did not receive a certain number of his quarterly dividends he had the right to vote. Thus, this contingent control was the weapon

he might use whenever he was not paid his dividends. Bond holders will not always sell the property; and seldom do they do so advantageously. Preferred stock holders were not always given the power to sell the corporation; but contingent control might prove as effective as the possibility of foreclosure in the case of the bond holder. Fourth, the amortization provision was a very characteristic bond feature, but the greater flexibility in application was characteristic of preferred stocks.

The preferred stock provisions underwent an almost continuous development. The first two industrials of this class were the United Cigar Manufacturers and Sears Roebuck. In the case of the United Cigar Manufacturers, there were no quasi-bond features attaching to the preferred stock beyond the provision that the dividend should be cumulative. There was a greater complexity in the provisions of the Sears Roebuck preferred; but it was not until later that the standard provisions were developed. The preferred stock holders were looked upon as a type of partners in these earliest companies, and in the absence of any provision for retirement, they remained partners. Subsequently, the United Cigar Manufacturers Company found it disagreeable to be forced to retain these partners after they could have dispensed with them. The preferred stock provisions in the incorporations that followed evidenced a change in attitude on the part of the owners and bankers. Preferred stock holders came to be considered as a lenient type of bond holder. Sears Roebuck at first planned to issue bonds, but they were shown the advantages of preferred stock and the desirability of being able to put off a dividend payment if necessary. The provisions for amortization in any issue of industrial bonds would have been severe; whereas preferred stocks could be retired in good times and kept out in times of depression.

The writers who have argued that these industrial corporations did not have large enough values in tangible assets for bond issues were certainly in error. Sears Roebuck, B. F. Goodrich, Deere, Studebaker, F. W. Woolworth

—all these businesses might have issued bonds instead of preferred stock. As a matter of fact, Deere and Studebaker did have small bond issues. It was not the lack of assets, but the variability of earnings which turned the scale in favor of preferred. These industrials, from their very nature, showed great fluctuations in earnings. The greater elasticity of the preferred stock was preferable to the rigid requirements of the bond. Instead of six per cent bonds, seven per cent preferred stock was issued. It was better to pay an extra one per cent for money when it could be borrowed on easier terms. The easier terms consisted in the possibility of letting a few dividend payments slip by, or in neglecting the sinking fund temporarily.

From the investor's point of view the preferred stock was practically as good as the bond. Conclusive proof of this is offered by the fact that those bonds which were put out by similar companies sold on about a six per cent basis, which was practically the basis on which the better preferred stocks sold. The interest on a bond in an industrial with great fluctuations in earning power might have received more immediate attention than the preferred dividends, but this prompt payment might have been detrimental even to the bond holder's ultimate interest. The preferred stock holder's position was practically as good as that of the bond holder except for the fact that he had no absolute mortgage on the company's assets. The possibility of contingent control and the prior lien on assets was not thought of primarily as a mortgage right; it was merely a weapon, and constituted a safeguard of a kind no different, for example, from that which results from the election of honest directors. Those preferred stocks which carried with them the greatest potential rights to effect dissolutions probably sold at no higher prices than those which had the smallest amount of contingent control.

Naturally, the subject of bond issues in these industrials is not of great importance. The difficulty of the Rumely Company when it was unable to meet its interest obligations was evidence of the danger of a bond issue for a new com-

pany with great fluctuations in earning power. Studebaker converted large outstanding liabilities into an issue of $8,000,000 of 5 per cent serial gold notes, which were retired rapidly. This bond issue occurred only a year after the original flotation and was the result perhaps of the under-capitalization of the preferred issue. There were no reasons, other than technical ones, why Studebaker did not issue more preferred stock rather than bonds. Stern Bros. changed a bond issue into one of preferred stock, but merely for reasons of taxation. Deere and Co. had a bond issue before the preferred stock flotation, and retained it after the flotation.

CHAPTER VII

The Success of the New Industrial Corporations

A valuable judgment as to the success of these flotations would require as its basis a longer experience than is available. A record of only a few years, affected by such an abnormal influence as the European War, makes the task of generalization difficult and of doubtful value. There are at least four different points of view from which their success might be appraised. The owner, the banker, the investor, and the public undoubtedly had different opinions as to what constituted success. In many respects there was agreement, but the conflicts of interest were numerous.

The owner's primary interest was the net profits. After incorporation, as before incorporation, he was interested in having his business make more each year. Provided he held the common stock or a part of it, he wanted large earnings. It made little difference whether those shares represented large or small portions of the business; the more the business made, the more he received. The assumption was that the man who managed the business held the bulk of the common stock. The bankers, in many cases, as has been said, tried to enforce this, if only for a limited number of years. If the man or men who managed the business did not own any considerable part of the common stock, the owner (in the sense that he is defined here) did not really exist, as an independent factor. Of course, the owner may have had a great temporary interest in the price of the preferred stock, if he wanted to unload a block of his preferred holdings. But generally speaking, the actual earnings over and above all preferred dividends were the owner's principal concern.

The banker, too, was interested in earnings, because they affected the securities which he had created. The good

reputation of the preferred stocks, which he had sold his customers, was a matter of great importance to him. Upon their safety and their dividend paying regularity his reputation rested. Furthermore, inasmuch as he had received common stock bonuses in return for his work, he had a direct interest in the price of the common stock. The banker's interest was, thus, closely allied to that of the investor. However, the buyer of preferred or common stocks may at times have had a very different point of view from that of the banker. The buyer of preferred stocks may not have considered only regularity of dividends; he may have bought for a rise. The bankers and the buyers of common stock may have had very different ideas as to what policy was proper with respect to common dividends.

How the flotation of these companies on the stock exchange affected their earnings is not an easy question. In some cases the increase in net profits after incorporation was due to an accounting technicality. If a business used any of the proceeds from the preferred to pay debts on which it had been paying interest, its earnings for dividends were increased since the interest paid before incorporation was subtracted, whereas no part of the preferred dividend was deducted in computing profit. It might be conjectured that the new method of financing, made possible by these flotations, may have brought about an increase and even a greater stability in earnings. On the whole, however, those companies, from which the owners withdrew the proceeds obtained from the sale of the preferred, showed as great and even greater success than the others.

The companies which had the least success were the agricultural implement companies. (See last two tables at the end of this chapter.) Some of them had issued bonds before the general spread of the new form of capitalization but not to the same extent as in the subsequent period. These companies had had great fluctuations in earnings before 1911 and 1912; but the greater possibility of marketing securities after flotation may have helped to bring on the disasters which they suffered.[1]

[1] See appendix i.

One bad effect of the flotation of these businesses, which was indirectly prejudicial to the owner's interest, was the belief in certain cases in the necessity of declaring and paying common stock dividends, which were not earned. In 1914, when Brown Shoe had no justification whatsoever, a dividend of 3 per cent was declared on the common stock. Manhattan Shirt declared a dividend in 1915, after three years of steady fall in earnings. The May Department Stores Co., in the same year continued a dividend of 5 per cent when its earnings offered no justification for such a policy. The need of a good showing and the publicity attendant upon these dividends probably suggested a degree of generosity which a private corporation would not have considered.

The effect of the advertising value of these flotations on the earnings was believed to be considerable. In the report of Loose Wiles for its bad year 1915, the president of the company exhorted each stock holder to become a patron and "rooter" for the Sunshine biscuit. The effect of being listed on the stock exchange on the businesses of Woolworth and Kresge may seem inconsequential; nevertheless, those in a position to know believed it a matter of some value. In the case of B. F. Goodrich, of Sears Roebuck, and of Underwood Typewriter, the flotation was said to have furnished effective advertisement.

A study of the actual earnings of these companies before flotation, as given in a preceding chapter, shows that the most successful businesses from the point of view of the owner were those whose earnings were stabilized either because they satisfied varied demands or depended upon the supply of no one particular raw material. The chains of five and ten cent stores and Sears Roebuck were the most successful industrials because they were not seriously affected by any one local or particular disturbance. (See tables at the end of this chapter.) No one section of the country, no one raw material, no one demand was able to do them injury. These conditions were not altered by the reincorporation of the companies. The May Department

Stores was too small a chain not to have been affected by the local difficulty which the Pittsburgh store encountered. The Brown Shoe showed decreases in earnings because of the fall off in the local demand, and B. F. Goodrich because of the decline in the value of its inventories of raw material.

There was another class of persons who held common stock besides the owners and the bankers, namely, the investors. As has been explained, the owner was not ordinarily so vitally interested in the actual value or yield of each particular share of common stock, but the banker and the buyer of such stock did have that interest. As far as dividends on these common stocks were concerned, there were not a great many paid. The price of the common stocks, however, rose in most cases with the natural increases in earnings; and most of them shot up to high figures after the outbreak of the European War. On the whole, these industrials paid their preferred dividends but few of them showed any regularity in dividends on the common.

The effect of the capitalization on the subsequent history of these common stocks is very interesting. Other things being equal, a conservatively capitalized common stock was naturally more valuable than a less conservatively capitalized one. But those companies which had comparatively large common issues at the time of incorporation (that is, companies which showed a small percentage earned on the common) were less tempted to declare dividends even though their earnings might have increased as rapidly as those of the more conservatively capitalized companies that did declare dividends. These did not pay dividends partly because the dividends which they could have declared would have been insignificant. Thus, the money was returned to the business and expansion was possible. Of course, Studebaker had a bad year in 1913; but afterwards the policy of not paying common dividends brought good results, whereas Willys-Overland did a remarkable business all along, but paid large dividends, some of which perhaps ought to have been returned to the business. Hart,

Schaffner & Marx showed only 3.9 per cent on the common at the time of incorporation. In the first year thereafter, even less was earned on the common, but as the earnings improved they were not distributed in dividends. Nothing was paid on the common until the small dividend of one per cent in 1915. Hart, Schaffner & Marx was unable to pay large common dividends, and thus kept the surplus earnings in the business for purposes of expansion. This raises the question as to whether those companies which were less conservatively capitalized were not in the end really better off. Of course, from the common stock holder's point of view the absence of dividends was not always looked upon so favorably.

An interesting illustration of the relation between capitalization and the payment of common stock dividends is furnished by a comparison of Woolworth and Kresge. Woolworth had a much less conservative preferred issue than Kresge but a much more conservative common one. Even though the earnings of Kresge advanced as rapidly as those of Woolworth and at certain periods much more rapidly, Woolworth paid much more in common stock dividends. Kresge put all surplus earnings back into the business and as a result showed a much more remarkable expansion than Woolworth. From the point of view of the common stock holder the Woolworth method of financing was more advantageous in most respects; but from almost every other point of view the Kresge method led to safer and better results. (See tables at the end of this chapter.)[2]

The apparently fortunate outcome of what was actually often an over-capitalized common stock shows, on further study, a definite relation to another circumstance. Many of the companies which in 1911 and 1912 had large common stock issues pulled through because of the great increase in earnings resulting from the European War. Many companies, which would have been earning little or nothing on their common issues and would have paid no dividends, made great strides after the outbreak of the War.

[2] See appendix iv.

B. F. Goodrich had had a difficult time after incorporation, but the War brought it prosperity. And this is but one example. It is an interesting question whether it was the earnings on these common stocks or the dividends paid which had most to do with the price for which they sold in the market. Of course, the amount earned might have had less effect on the prices for the common stock in any year, as the report was usually not published until the end of the year. Furthermore, many buyers who made no extensive calculations were satisfied that where large dividends were paid there must have been large earnings. As a matter of fact, the prices of these stocks rose with the increases in earnings and the increase in the earnings on the common stock, but the effect of the actual payment of dividends on the prices of the common stocks was far more noticeable. The great increase in the earnings of Studebaker in 1914 had no effect on the depressed prices of the common, but the dividend in 1915, which, of course, was the result of great progress in earning power, sent the stock to a high level. Kresge and Woolworth common showed the great influence of dividends on the prices of these stocks in the market. Of course, dividends which were obviously too large did not have the same effect. The 4 per cent dividend paid by Cluett-Peabody in 1914, clearly a bad year for that company, caused only a small rise in the value of the common stock, which had never before paid a dividend. Too large a dividend, which might have hindered expansion and even have hampered the regular business of a company deceived no careful investor.

Certain special circumstances explain why some of these preferred stocks sold at a higher price than others equally as good. First, the larger and better known the company, the higher was the price of the preferred stock, other things being equal. Kresge's preferred issue was more conservative than that of Woolworth. Yet Woolworth preferred sold at a higher price than Kresge preferred.[3] Second, those preferred stocks which were listed on the New York

[3] The low redemption price of Kresge (110) undoubtedly influenced the selling price.

Stock Exchange sold usually at a relatively higher price than those on the smaller exchanges.

The failure of the preferred stocks in the agricultural implement companies was noted in the preceding chapter. It is enough to say that three of the six companies analyzed were unable to pay all their preferred dividends. With the exception of Maxwell and Loose-Wiles, there were few other companies which were unable to meet the preferred dividend requirements. Thus, on the whole, as far as dividends were concerned, these new industrial preferred stocks were successful. Furthermore, these stocks rose in value from year to year. Just what where the most important factors in the fluctuations of the preferred stocks is a difficult question. The factors, however, which might have been expected to have had an immediate influence on the price of the preferred stock were the tangible assets, the earning power, and the price of the common stock. Of course, the tangible assets and the earning power in any year had less influence on the prices of the stocks for that year from the fact that the reports were not published until the end of the year. Furthermore, the actual effect on the prices of preferred stock was much less considerable than might have been expected. The prices of preferred stocks seem to have been influenced more by the prices of the common stocks than by any other factor. The records of Kresge, Woolworth, Goodrich, Goodyear, and Underwood Typewriter are but a few of the many cases which illustrate this point.

The banker was naturally interested in the preferred stock in so far as his reputation depended to a large extent upon the success of the preferred issue. The actual holder of the preferred stock was the one most vitally interested. The banker cared chiefly about the safety of the yearly dividend and the absence of any material decline in the price of the stock. But the holder might have anticipated in addition an actual rise in value or an early redemption. On the whole, bankers and preferred stock holders were satisfied. With the exception of one industry and certain

other sporadic cases, the preferred stocks paid their regular quarterly dividends and rose steadily in value, as shown in the following table:[4]

Companies	1912	1913	1914	1915	1916	1917
Deere	100– 99	100– 91	99– 91	99– 85	99– 89	101– 91
Case	101– 99	103– 90	95– 80	90– 74	90– 82	88– 75
Rumely	103– 98	100– 33	40– 21	18– 2	43– 30	37– 19
Emerson-Brantingham	102– 98	101– 91	76– 72	—	—	—
B. F. Goodrich	109–105	105– 73	95– 79	114– 95	116–110	112– 91[a]
Goodyear	—	105– 97	102– 92	115–100	—	108– 92
Studebaker	98– 90	93– 64	92– 70	119–91	114–108	108– 85
Willys-Overland	101– 99	99– 80	96– 90	115– 95	117– 94	100– 92
Maxwell	—	35– 18	48– 22	104– 43	93– 65	74– 49
Woolworth	118–109	115–109	118–112	124–115	126–123	126–113
Kresge	105–100	102– 96	105– 99	112–104	12– 10	113– 83
Acme	—	—	—	—	98– 93	96– 92
Jewel	—	—	—	—	113–104	112– 90

It would appear that the values of the preferred stocks should have borne some definite relation to the values of the tangible assets behind them. Even if such a relation existed, it would have been complicated somewhat by the redemption values of these stocks. For example, Goodyear preferred stock, which up to 1915 was much better secured than B. F. Goodrich preferred stock, never sold above $105, whereas B. F. Goodrich sold at $109. The redemption value of Goodyear preferred was $115 while that of B. F. Goodrich preferred was $125.[5]

No very definite relation between the prices of these stocks and their safety coefficients, that is, ratios of tangible assets to the preferred stocks, seems to exist. The earnings of the various companies must be taken into consideration. The prices of the agricultural implement preferred stocks reflected the general instability in the industry. The chain store preferred stocks were apparently the most stable investments.

[4] These prices were obtained from the Annalist and from Investors' Manuals.
[a] Ex-dividend.
[5] See appendix ii.

The ratios of the tangible assets to the preferred stocks were as follows:[6]

Companies	1912	1913	1914	1915	1916	1917
Deere	1.19	1.09	1.20	1.25	1.29	1.25
J. F. Case	—	1.75	1.84	1.89	1.93	1.98
Rumely	2.20	1.59	([b])	1.03	.99	.96
Moline	—	2.19	2.20	2.22	2.23	2.26
Emerson-Brantingham	1.45	1.49	1.45	1.46	1.46	1.53
B. F. Goodrich	—	—	.96	1.08	1.60	1.73
Goodyear	4.80	2.40	2.68	2.80	1.25	1.55
Studebaker	1.80	2.18	2.19	3.06	3.49	2.95
Willys-Overland	—	—	—	3.96	4.85	4.38
Maxwell	—	—	3.93	4.61	5.35	3.10
Woolworth	1.00	1.22	1.40	1.60	1.86	2.11
Kresge	1.22	1.50	1.70	2.25	3.40	4.21
McCrory	—	—	—	1.80	1.95	2.19
Acme	—	—	—	—	1.05	1.49
Jewel	—	—	—	—	1.49	1.74

A very much more definite relation between the earnings on the common stocks and the market prices of those stocks is clearly discernible. The following tables show how closely market prices and earnings were related. The net earning on the common stocks were as follows:[7]

Companies	1912	1913	1914	1915	1916	1917
	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
Deere	12	8	— 3	3	19	14
Case	17	6	2	14	10	18
Rumely	13	10	−36	—	−165	−36
Moline	—	10	2/10	9/10	4	10
Emerson-Brantingham	—	3	— 9	−5	−5	8/10
B. F. Goodrich	5	1	5	6	12	14
Goodyear	125	74	59	58	36	62
Studebaker	6	4	14	27	26	9
Willys-Overland	—	—	—	53	40	21
Maxwell	—	—	12	16	21	31
Woolworth	12	15	20	23	20	17
Kresge	9	11	11	13	16	17
McCrory	—	—	—	—	7	5
Acme	—	—	—	—	10	11
Jewel	—	—	—	—	14	25

[6] These figures were calculated from data in Moody's Manuals of Industrials.
[b] Reorganization.
[7] These figures were obtained from data in Moody's Manuals of Industrials.

The market prices of these common stocks were as follows:[8]

Companies	1912	1913	1914	1915	1916	1917
Deere	101– 89	92– 13	18– 6	14–78	21– 14	18– 7
Emerson-Brantingham	77– 65	69– 22	—	—	—	14– 12
B. F. Goodrich	86– 60	68– 15	28– 19	80– 24	80– 57	61– 32
Goodyear	—	443–279	250–150	340–191	—	281–136
Studebaker	49– 30	36– 15	36– 20	195– 35	167–100	110– 79
Willys-Overland	72– 67	75– 50	91– 58	268– 84	81– 35	38– 24
Maxwell	—	1– 5	3– 16	92– 15	99– 44	61– 43
Woolworth	118– 76	112– 81	103– 89	120– 90	141–118	115–100
Kresge	89– 47	83– 58	105– 81	260– 99	16– 10[c]	13– 10[c]
Acme	—	—	—	—	96– 67	78– 31
Jewel	—	—	—	—	69– 51	58– 52

[8] These prices were obtained from the Annalist and from Investors' Manuals.

[c] Value of common reduced to a par of $10.

CHAPTER VIII

A Social Estimate of the New Industrial Corporations

It is a well known fact that the larger a business becomes, the greater is the need of some form of finance by flotation. Small undertakings can finance themselves satisfactorily through the commercial banks and from private sources, whereas large undertakings usually must have recourse to the public sale of securities. Perhaps because stocks and bonds are long time instruments they were once considered proper only for quasi-governmental enterprises, namely, railroads, public utilities, etc. As industrial enterprises have increased in size on account of the advantages of large scale production, the method of flotation has been employed more and more by industrial corporations. However, it is doubtful whether it is socially desirable that some of the businesses quoted on the exchange today should be there. It would have been, perhaps, to the interest of all concerned—investors, the bankers, and the owners—had the stocks of such businesses not been sold on the stock exchange.

One of the most important functions claimed for the stock exchange grows out of the speculator's assumption of risks and the resultant stabilizing effect on the stocks of companies with great fluctuations in earnings. There is, however, a limit to this doctrine. It is uneconomic for a business which could have been financed from private sources to impose large risks on the market, which is always best off when the fluctuations in it are small. The speculator, who is often as much gambler as student, is thus tempted to assume responsibilities which could better have been undertaken by the men who control the business of the corporation. Furthermore, instability in the earnings of an industrial corporation that affects only the common

stock is far less dangerous and much less important than an instability so great that the safety of the preferred stock is threatened. Preferred stocks, generally speaking, are reasonably safe investments; and a business which does not anticipate paying its preferred dividends regularly and easily has no right to sell such securities to the public. The greater the stability of a business, the more justification there is for shifting its risks to the market.

It may generally be said that the larger a business is, the greater will be its stability. However, size, as it is well known, is by no means the only element in stability. It was shown in the foregoing chapter that those businesses which catered to but a single demand and which depended upon the supply of only one or two raw materials, were the first to encounter temporary difficulties with disastrous results. The experience of the B. F. Goodrich Company, of the Brown Shoe Company, and of the Cluett Peabody Co. furnish good examples.[1] A company which finds the prices of its raw materials rising often cannot recuperate by an immediately increased price for the finished product. The customary price, which the Cluett Peabody Co. or the Loose Wiles Biscuit Co. had to maintain, could not immediately be altered when the price of linen or the price of sugar increased rapidly. Notoriously unstable businesses like the agricultural implement companies should never have been brought into the market. On the other hand the most successful companies have been those which catered to varied demands, that is, Woolworth, Kresge, Sears Roebuck.[2] The successful chain store company was particularly suited to flotation. The difficulty with the May Department Stores lay in the fact that the chain was so small that a local difficulty affected the success of the chain to a large degree. Companies with trade names that appeal to the popular imagination were thought by some bankers to be especially suited to public flotation.

One economic question which seems to have been par-

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[1] See appendix ii.
[2] See appendix iv.

ticularly interesting to the bankers was concerned with the advantages of combining businesses as a basis of flotation. It must be understood that a combination, such as those of Woolworth or the May Department Stores, was very different from a combination like that of the B. F. Goodrich Company and the Diamond Rubber Co. In the cases of Woolworth and May, businesses were combined which did not compete with each other and which were but slightly affected by the combination. There was a single management, whereas before incorporation there had been a few independent businesses. When B. F. Goodrich and the Diamond Rubber Co. were combined, the healthful competition which had stimulated salesmanship and the trade name of the Diamond Rubber Co. were lost. When the banker who had brought about the combination of these two companies was to float a later combination of the same kind, he feared the same difficulties which he had encountered in the B. F. Goodrich Company. As Dewing has shown, few of the industrial combinations obtained a sufficient control of the trade to command prosperity.[3]

The financial exigencies which were responsible for the incorporation or reincorporation of these companies were classified, and described at length in a former chapter.[4] The owners, who invoked the financial aid of a flotation, and the investors and the bankers, whose security holdings were the results of these financial needs, naturally took great interest in the purposes of these flotations and had definite ideas as to how this new capital would be of advantage from their own particular points of view. Certainly the social estimate of the desirability of the employment of these large amounts of capital must take into consideration the interests of these agents in economic production, but it will take into account other interests as well. The personal motives of the owner are not hard to understand. Here was a great business which he had built up, in most cases, slowly and laboriously. As he was growing older he felt that it was desirable to sell stock to those who were

[3] Dewing, Corporate Promotions and Reorganizations, p. 565.
[4] Chapter iii.

anxious to get it, and thereupon he withdrew his invested capital. He did not want all his eggs in one basket, for if danger befell his business his declining years might be threatened with disaster. Of course, from an economic point of view, much depended upon what other baskets he chose for the eggs. Society is interested in the economic employment of capital. One of the most important functions of a bank is the transfer of capital from those who own it, but who do not know how to use it, to those who need it and know how to use it. Assuming that the owner who withdrew his capital was as wise in appraising other ventures as he had been in the promotion of his own and that his business experience through many years had made him even keener and more efficient, there is reason to believe that the capital which he withdrew was reinvested economically. However, if, with advancing age, caution and conservatism suggested the reinvestment of the capital withdrawn in government bonds, it is doubtful whether the effects of such a flotation were economically beneficial.

Those businesses which were incorporated in order to obtain working capital for expansion made, perhaps, the most legitimate use of corporation finance from an economic point of view. That this was recognized by the owners was shown in practically every prospectus which made a definite and open avowal of the purpose of procuring working capital for expansion. Expansion by means of the public sale of securities is a recognized method of corporation finance, but the question naturally arises as to whether many of these new industrials really needed or were justified economically in their use of the methods of corporation finance to obtain this capital. It was explained earlier in the chapter that those businesses which were small and which were lacking in stability had less justification for throwing risks on the stock market than those which were larger and more stable. Furthermore, the smaller businesses should have been able to finance themselves in the usual way through the commercial banks if they had good credit. The great expenses of the flotations must also be

considered. There is one other consideration of interest with regard to those businesses which obtained capital for expansion. Where a business borrowed money in the market instead of in the bank, or when it liquidated its outstanding liabilities with the borrowed capital, its credit was perhaps increased with the bank. A further issue of securities in a market which was acquainted with the company was also usually a possibility. Thus, the question arises as to whether these flotations did not allow and whether they might have even encouraged a too rapid expansion. The charter provisions with regard to the preferred stock[5] and with respect to borrowing in general as well as the publicity afforded by the annual statements were the most effective restrictions on the possible tendency towards a too rapid expansion. It was a common belief that the banker, who was usually a director, actuated by self-interest, wisdom, and conservatism, furnished a check on any policy of unwarranted expansion. As a matter of fact, the bankers usually had little control after the flotation of the stock. The charter provisions were their only weapons and safeguards. The banker who financed a business before its public sale had in many respects a much more effective control of it than he could have after if it had been financed by the marketing of its stock.

[5] Given in full in chapter vi.

APPENDIX I

Introduction

The four industries in which the capitalization of industrial goodwill has been most noteworthy are the farm implement industry, the rubber tire industry, the automobile industry, and the chain stores. For this reason brief analyses of the rise, spread, and success of stock flotations in these industries have been prepared. These analyses furnished material for a number of the conclusions reached in the foregoing chapters. The data for these analyses were obtained from Moody's and Poor's Manuals of Industrials, the Annalist, Investors' Manuals, and from other original sources.

Although some knowledge of accounting is indispensable for a thorough comprehension of these analyses, only a few terms need be explained for the general reader.

By "Sales" is usually meant "Net Sales," i.e., "Gross Sales," with deductions for "Outgoing Freight," "Discounts," and "Allowances."

By "Investment" is meant "Capital Stock," "Bonds," and "Surplus," with deductions for "Goodwill" and "Outside Investments." "Short Term Notes" would have been included if their duration could have been ascertained.

By "Tangible Assets" is meant "Capital Stock" and "Surplus," with deductions for "Goodwill."

By "Profit" is meant the accountant's "Gross Profit," i.e., profit and interest. In some places "Profit" refers to the accountant's "Net Profit," i.e., gross profit with bond interest deducted (as in the profit earned on the common stock).

The Farm Implement Stock Flotations

1. *The Reasons for the Preferred Stock Flotations*

The M. Rumely Co., together with the companies which it absorbed in 1911 (the Gaar Scott Co., the Advance

Thresher Co., and the J. I. Case Threshing Machine Co.), were the most important threshing companies in the industry. These large thresher companies stated at the time of their flotations in 1911 and 1912 that they desired to develop the manufacture of other kinds of farm implements, particularly tractors and portable engines. The Emerson-Brantingham Co., which had confined its output to "walking, riding, and engine plows, disc plows, harrows, pulverisers, seeders, planters, middle breakers, cultivators, listers, alfalfa renovators, stalk cutters, mowers, and rakes," acquired two new plants in order to develop a business in "tractors, threshers, hay stackers, hay presses, corn shellers, etc." The Moline Plow Co., which had manufactured wagons and plows, acquired by means of its second preferred stock the Adriance, Platt and Company, a large binder plant. The John Deere Plow Co., which had always been one of the most important plow manufacturing companies, developed under the name of Deere and Co. into the most important independent "full line" company.

In the Report of the Bureau of Corporations (March 1913) on the International Harvester Company, it was stated (page xx) that since the organization of the International Harvester Company in 1902 new competition had begun to appear, "especially from certain large plow and tillage-implement makers, whose fields have been invaded by the combination, and who likewise have arranged to establish a 'full line'—that is, a large assortment of the chief kinds of farm implements. This new competition is apparently of great significance. However, in 1911 the International Harvester Company still had about 80 per cent of the production of binders, 78 per cent of the production of mowers, and 72 per cent of the production of rakes."

Apparently the flotations of preferred stock by the independent companies represented the means by which they were enabled to develop "full lines" or, at least, new lines. The International Harvester Co. had invaded their fields, and they desired to wage offensive warfare.

In addition to this motive, there was probably another which influenced the threshing machine companies (J. I. Case and M. Rumely) to issue preferred stock. Parts of their preferred stocks were used to wipe off bonded indebtedness and other liabilities. This was particularly true of the J. I. Case preferred stock, which was to be used "to redeem and cancel all the outstanding bonded debt ($2,300,000), and along with bills receivable ($9,405,643) to retire the bills payable ($5,425,000) as well as for increases in plant and manufacturing facilities ($1,200,000)." The M. Rumely Company had $1,000,000 of bonded indebtedness which was wiped off by the preferred issue. The threshing machine was an expensive machine, and was usually bought on credit and paid for by installments. Thus, a threshing machine company had great difficulty in financing itself inasmuch as it had to extend so much credit. It should be noted, furthermore, that the Moline Plow Co. also desired to retire its floating indebtedness.

2. *Case, Deere, Rumely, Emerson-Brantingham, and Moline Before 1912*

The preferred stock flotations of the farm implement companies occurred in 1911 and 1912. A comparison of the accounts of the five independent companies in 1910 and 1911 will serve to estimate their success before their re-incorporation.

Companies	Ratio of Gross Profits to Gross Sales (%)	Ratio of Net Profits to Gross Sales (%)
	1910	
Deere	13[a]	12[a]
J. I. Case	16	12
M. Rumely	10	5
	1911	
Deere	13[a]	12
J. I. Case	18	12
M. Rumely	15	13
Emerson-Brantingham	—	16

[a] Estimated.

3. *The Success of the Farm Implement Flotations*

The earnings of these companies on their investments between 1912 and 1917 show that they failed to obtain the success they anticipated in 1911 and 1912. Their reports, however, were better on the whole in 1917 than in the previous years.

The profits on investment were as follows:

PERCENTAGE OF PROFIT EARNED ON INVESTMENT

Companies	1912	1913	1914	1915	1916	1917
Rumely	10	19(b)	—	—	4	5
Emerson-Brantingham	—	7	Loss	.6	1	3
Moline	—	7	4	3	4	10
Deere	10	12	6	9	10	12
Case	9	8	6	9	8	13

4. *The Preferred Stock of the Farm Implement Companies*

The relations of the preferred stocks to the tangible assets for the five companies were as follows:

TANGIBLE ASSETS DIVIDED BY THE PREFERRED STOCK

	1912	1913	1914	1915	1916	1917
Deere	1.19	1.09	1.20	1.25	1.29	1.25
J. I. Case	—	1.75	1.84	1.89	1.93	1.98
Rumely	2.20	1.59	(c)	1.03	.99	.96
Moline[1]	—	2.19	2.20	2.22	2.23	2.26
Emerson-Brantingham	1.45	1.49	1.45	1.46	1.46	1.53

The preferred stock issues, thus, were conservative. Apparently no great amounts of money were put back in the business as the increases in the foregoing percentages were not great. However, the preferred stocks were not retired (i.e., amortized) so generally in these companies as in the case of most of the other industrials.

The prices of these preferred stocks were as follows:[2]

[b] Loss.
[c] Reorganization.
[1] Reports do not show exact amount of goodwill.
[2] Fractions omitted.

	1912, High–Low	1913, High–Low	1914, High–Low	1915, High–Low	1916, High–Low	1917, High–Low
Deere	100–99	100–91	99–91	99–86	99–89	101–91
J. I. Case	101–99	103–90	95–80	90–74	90–82	88–75
Rumely	103–98	100–33	40–21	18– 2	43–30	37–19
Emerson-Brantingham	102–98	101–91	76–72	—	—	—

The ratios of these preferred stocks to the tangible assets, however, bore no definite relation to the market prices of the stocks when the earnings of the companies fell off. The preferred stock of Deere held up best, and that of Case held up fairly well, but the industry's bad year of 1914 seriously affected the market values of most all of these stocks.

Case and Deere have always paid the 7 per cent preferred stock dividends, but Rumely preferred paid nothing in 1914 and Emerson-Brantingham paid only $5\frac{1}{4}$ per cent. The preferred dividends of these companies were as follows:

	1912	1913	1914	1915	1916	1917
Deere	7	7	7	7	7	7
Case	7	7	7	7	7	7
Rumely	7	$3\frac{1}{2}$	–	–	–	–
Moline	7	7	7	7	7	7
Emerson-Brantingham	7	7	$5\frac{1}{4}$	0	0	0

5. *The Common Stocks*

The common stocks of most of these farm implement companies were not traded in extensively on the stock exchanges. The prices of the Deere and Emerson-Brantingham common stocks were as follows:

	1912, High–Low	1913, High–Low	1914, High–Low	1915, High–Low	1916, High–Low	1917, High–Low
Deere	101–89	92–13	18–6	14–7/8	21–14	18– 7
Emerson-Brantingham	77–65	69–22	—	—	—	14–12

The earnings of these companies on their common stocks throw light on the low prices of those listed and explain

why they were so little traded in. The percentages earned on the common stocks were as follows:

	1912	1913	1914	1915	1916	1917
Deere	12	−8	−3	3	19	14
Case	17	6	2	14	10	18
Emerson-Brantingham	—	3	−9	−5	−5	1
Rumely	13	10	36	—	−165	−36
Moline	—	10	2	1	4	10

APPENDIX II

The Rubber Tire Stock Flotations

1. *The Rubber Tire Industry Before the Preferred Stock Flotations in 1912*

The rubber tire industry is an industry of comparatively recent growth, and has developed simultaneously with the automobile industry. The development of the automobile would have been practically impossible had it not been for the pneumatic rubber tire. The great expansion in the rubber industry, furthermore, has resulted from the demand for automobile tires.

In the Census of Manufacturing of 1914, figures for the tire industry were first given separately. The development of the combination in this industry, the United States Rubber Co., preceded this Census by a number of years. In the report of the Industrial Commission of 1901 the dominant position of the United States Rubber Co. was set forth. But the company developed its business in other lines, e.g., shoes, belting, hose, etc. A comparison of the figures in the Census of 1909 with those of the Census of 1914 will show that the rubber industry grew rapidly in these five years and that the increases resulted chiefly from the development of the tire industry.

The development in the use of automobile tires in 1909 and 1910 and its effect on the business of the tire companies are shown by the following figures taken from the Fisk prospectus:

Year	Automobile Casings	Automobile Inner Tubes	Bicycle Tires
1908......	57,695	40,960	84,387
1909......	78,259	59,077	103,085
1910......	96,692	88,061	168,990
1911......	125,279	121,584	207,561
1912......	221,826	198,925	240,623

In 1902 the United States Rubber Co. and the Rubber Goods Manufacturing Co. controlled nearly 60 per cent of the industry, but by 1914 not much more than one-fourth of the rubber manufacturing business was in the hands of the United States Rubber Company.[1] In 1914 the sales of the United States Rubber Co. were about 85 per cent as great as the combined sales of the three largest companies (B. F. Goodrich, Goodyear, and Firestone), while in 1917 this percentage was only about 67 per cent. The trade names of the independent companies proved of great value.

The United States Rubber Co., furthermore, did not increase its sales from 1910 to 1912, whereas the large independent companies showed considerable increases prior to 1912. In the following figures the sales of 1910 are used as a base:

Year	United States Rubber Co.	B. F. Goodrich	Goodyear	Fisk
1910	100	100	100	100
1911	105	106	139	116
1912	95	192	264	165

The United States Rubber Co. made a somewhat greater margin of profit on sales than the other two companies for which figures are available, i.e., Goodyear and Firestone.

2. *The Reasons for the Preferred Stock Flotations*

The independents, B. F. Goodrich, Goodyear, and Fisk, issued preferred stock apparently for the purpose of securing funds for expansion. The Goodyear prospectus gives the following as the purpose of the preferred issue: "Of the authorized issue of $5,000,000 Preferred Stock, $1,000,000, was issued to retire a like amount of Preferred Stock formerly outstanding, and the remaining $4,000,000 to provide additional working capital to meet the growing demands of the business." The reason for the B. F. Goodrich flotations was the desire for expansion through the

[1] The Rubber Goods Manufacturing Co. was controlled by the United States Rubber Co.

purchase of the Diamond Rubber Company. Apparently the promoters had no idea of forming a combination in restraint of trade or of attempting any kind of monopoly; the acquisition of the Diamond Rubber Company seems to have grown out of the desire to gain the well recognized economies of large scale production,

The entire proceeds from the preferred stock issues of these companies were not used in every case for the purpose of expansion. Apparently the owners of these companies withdraw a part of their investment from the business when their preferred stock was floated.

3. *The Sales of the Rubber Tire Companies after the Flotations of 1912*

Following the flotations of 1912, the sales of the independent companies increased more rapidly than the sales of the United States Rubber Co. In the following table the sales of 1913 are used as a base:

Year	United States Rubber	B. F. Goodrich	Goodyear	Fisk
1913	100	100	100	100
1914	91	121	94	117
1915	101	140	111	147
1916	138	180	194	210
1917	191	221	338	322

The sales of the United States Rubber Company were larger than those of any of the independents, and therefore the percentage of increase might have been expected to be less rapid for the larger company.

4. *The Profits of the Rubber Tire Companies*

The ratios of the profits (gross profits before the deduction of interest) to the sales were on the average greater for the United States Rubber Co. than for the other companies. For the five years since incorporation, the United States Rubber Co. averaged about 14 per cent on sales, Fisk about 8 per cent, and the other companies about 12 per cent. The profits earned on sales were as follows:

PERCENTAGE OF PROFIT EARNED ON SALES

Year	U. S. Rubber	B. F. Goodrich	Goodyear	Fisk	Firestone
1909....	—	—	15	—	—
1910....	18	—	15	—	—
1911....	12	—	10	—	8
1912....	12	9	12	—	10
1913....	11	6	6	5	10
1914....	14	10	20	7	17
1915....	15	21	14	10	17
1916....	13	13	11	8	13
1917....	18	13	13	12	8

The gross profits (i.e., profits and interest) on the investments for these companies were as follows:[2]

PERCENTAGE OF PROFIT EARNED ON INVESTMENTS[1]

Year	B. F. Goodrich	Goodyear	Fisk
1910......	—	72	—
1911......	—	31	—
1912......	—	64	—
1913......	7	17	9
1914......	16	29	15
1915......	36	29	29
1916......	24	36	19
1917......	26	41	21

Goodyear averaged more than 30 per cent, B. F. Goodrich about 22 per cent, and Fisk, 18 per cent between 1912 and 1917.

5. *The Preferred Stocks*

The equity in the preferred stocks of B. F. Goodrich and Goodyear, i.e., the preferred stock divided into the tangible assets was as follows:

Year	B. F. Gooodrich	Goodyear
1910..................	—	4.58
1911..................	—	4.10
1912..................	—	4.80
1913..................	—	2.40
1914..................	.96	2.68
1915..................	1.08	2.80
1916..................	1.60	1.25
1917..................	1.73	1.55

[2] The investment of the United States Rubber Co. was difficult to determine because the amount of "goodwill" is not stated on the balance sheet.

[1] Profit and Interest on Investment.

The Goodyear preferred stock was the safest because of the absence of water, but the redemption values were such that the high points for Goodyear and B. F. Goodrich were practically the same, as shown by the following figures:

	1911	1912	1913	1914	1915	1916	1917
B. F. Goodrich.....	—	109–105	105– 73	95–79	114– 95	116–110	112–91[a]
Goodyear..	—	—	105– 97	102–92	115–100	—	108–92
Firestone..	—	—	108–103	—	113–110	—	109–97
Fisk......	—	—	—	—	108[b]	—	—
United States Rubber Co......	115–104	116–105	109– 98	104–95	110–101	115–106	114–91

6. *The Common Stocks*

The earnings on the common stocks of these companies were as follows:

PERCENTAGE EARNED ON THE COMMON STOCKS

Year	United States Rubber Co.	B. F. Goodrich	Goodyear	Fisk
1910...........	10	—	151	—
1911...........	4	—	53	—
1912...........	6	5	125	—
1913...........	10	1	74	2
1914...........	8	5	59	5
1915...........	9	6	58	16
1916...........	15	12	36	16
1917...........	29	14	62	33

Goodyear showed the largest earnings because of the absence of "goodwill"; the United States Rubber Co. and Fisk showed about the same earnings on the common stock; B. F. Goodrich showed the least because of the large amount of "goodwill." These facts are reflected somewhat in the prices of the common stocks.

[a] Ex-dividend.
[b] At some closing during year.

Prices of Common Stock

	1911, High–Low	1912, High–Low	1913, High–Low	1914, High–Low	1915, High–Low	1916, High–Low	1917, High–Low
B. F. Goodrich	—	86–60	68– 15	28– 19	80– 24	80–57	61– 32
Goodyear	—	—	443–279	250–150	340–191	—	281–136
Firestone	—	—	360–122	—	804–365	—	150– 97
Fisk	—	—	—	—	126– 60	—	—
U. S. Rubber Co.	48–30	67–45	69– 51	63– 44	74– 44	70–47	67– 45

APPENDIX III

The Automobile Stock Flotations

1. *The Development of the Automobile Industry*

The automobile industry increased more rapidly in size and importance between 1904 and 1909 than any other industry. From an industry of almost negligible importance in 1900, it became one of the nine most important industries in the Census of 1914—with products valued at over $500,000,000. Coincident with the great increases in the size of the rubber tire industry between 1908 and 1911, the automobile industry also progressed rapidly. The following figures, which are probably not entirely accurate, show the development of the industry:[1]

Year	No. of Cars Produced
1898	200
1900	2,000
1902	9,000
1904	20,000
1906	39,000
1908	55,000
1910	180,000
1912	300,000
1914	560,000
1916	1,300,000

Naturally a rapidly expanding industry, such as this one, has needed capital, and has used the stock market as a means to procure it. This industry developed after the period of combination. The General Motors Co. was formed in 1908; but this company, large as it was, up through 1916 never produced much more than about 10 per cent of the total output of the industry. Ford, however, produced more than 35 per cent of the total output of 1916; and seven companies produced more than 75 per cent of the total production of automobiles in 1916. These

[1] Obtained from the reports of the Association and the Census of Manufactures.

companies were: Ford, General Motors, Studebaker, Willys-Overland, Chevrolet, and Maxwell.

The popularity of the cheaper variety of automobiles and probably a decreasing cost of production are shown by the following average prices paid for automobiles between 1904 and 1914:

1904	$1,382
1906	1,850
1908	1,621
1910	1,203
1912	1,000
1914	940

2. *Reasons for the Preferred Stock Flotations*

The preferred stocks of Studebaker and of Willys-Overland were floated in 1911 and 1912. The Ford Co. is practically a closed corporation, and the reincorporation of General Motors in 1916 was not the result of the same motives that were effective in the case of Studebaker and Willys-Overland. Studebaker and Willys-Overland were incorporated in 1911 and 1912 for the purpose of acquiring new capital for expansion. It was about this time that the industry began to expand.

3. *The Profits of the Automobile Companies*

The ratios of the profits to the investments (i.e., the percentage earned on investment) of automobile companies between 1911 and 1917 were as follows:

	1911	1912	1913	1914	1915	1916	1917
Studebaker	11.3	9.9	7.9	16.2	28.3	26.2	13.9
Willys-Overland	—	—	—	—	67.9	47.6	16.0
Maxwell	—	—	—	14.3	21.6	45.0	33.0
Packard	16.5[a]	16.2[a]	7.5[a]	15.5	33.8	20.5	—
General Motors	—	—	30.0	28.6	48.3	64.1	54.1

These automobile companies, like so many others, prospered remarkably during 1915 and 1916. In 1917, however, there was a decrease in the return on investment, due in part to the increase in investment in all cases except that

[a] Fiscal year.

of Studebaker. The decrease in the sales of Studebaker in 1917 explains the poor showing of this company in that year.

4. *The Equity in the Preferred Stocks*

The automobile preferred stock issues were conservative, as is shown by the ratios of the preferred stocks to the tangible assets:

	1911	1912	1913	1914	1915	1916	1917
Studebaker	1.67	1.80	2.18	2.19	3.06	3.49	2.95
Willys-Overland	—	—	—	—	3.96	4.85	4.38
Maxwell	—	—	—	3.93	4.61	5.35	3.10
General Motors	—	—	1.86	1.87	2.08	3.10	4.12

The prices of these preferred stocks were as high as might have been expected in view of their redemption values.

	1912, High–Low	1913, High–Low	1914, High–Low	1915, High–Low	1916, High–Low	1917, High–Low
Studebaker	98–90	93–64	92–70	119–91	114–108	108–85
Willys-Overland	101–99	99–80	96–90	115–95	117– 94	100–92
Maxwell	—	35–18	48–22	104–43	93– 65	74–49
General Motors	83–70	82–70	95–70	136–90	98– 89	93–85

5. *The Common Stocks*

The percentages earned on the common stocks of the companies were as follows:

	1912	1913	1914	1915	1916	1917
Studebaker	5.9	3.6	14.2	27.4	26.1	9.1
Willys-Overland	—	—	—	52.5	40.0	21.0
Maxwell	—	—	11.7	15.6	20.9	30.7
General Motors	—	38.0	38.0	82.0	170.0	170.0

APPENDIX IV

The Chain Store Stock Flotations

1. *The Development of the Chain Store*

The chain store dates back to about 1870. Between 1890 and 1900 it became a vital factor in American industrial life. The chain stores have had a marked tendency to reorganize our distributive system, by gradually replacing the jobber and the broker and by introducing the advantages of large scale production into retail business. In 1916 there were six firms in Philadelphia operating 461 chain stores. The chain stores have invaded many fields; department stores, shoe stores, hat stores, cigar stores, restaurants, drug stores, grocery stores, and five and ten cent stores, etc.

Of all the industrial corporations considered, none have been more successful than the chains of five and ten cent stores. In 1879 the first of the F. W. Woolworth stores was opened; from the surplus profits of that store another similar store was opened. The success of those two stores made possible the establishment of other stores in other localities. In 1915 Woolworth had 797 stores located in every State except Arizona, and in forty-six Canadian cities. The Kresge chain started in 1877, and had, perhaps, an even more phenomenal growth.

The Acme Tea chain and the Jewel Tea chain were begun in 1885 and in 1899 respectively. The Acme Tea Co. is one of the chain stores for which Philadelphia has become noted. In 1918 this company had 441 stores in Philadelphia, and also had stores in eighty cities and towns in the eastern part of Pennsylvania and New Jersey. The Jewel Tea Co. originally operated chain stores in Illinois; but in 1918 there were 550 branches in all the principal cities of the United States.

2. *The Reasons for the Chain Store Flotations*

The Woolworth flotation was brought out in the beginning of 1912, and the Kresge Flotation followed shortly afterwards. These companies apparently had no particular need of new capital, nor did they have large debts. The owners wanted to withdraw their investments, and put their consolidated chains on the market.

3. *The Sales and Profits of the Chain Stores*

The sales of the five and ten cent stores have not increased so rapidly on the whole as those of the grocery chains, although the sales of the Kresge showed remarkable growth. The following figures show the increases in sales (1912 was taken as a base of 100).

	1912	1913	1914	1915	1916	1917
Woolworth	100	109	115	125	144	162
Kresge	100	128	156	203	285	291
McCrory	100	113	103	118	142	164
Acme	100	104	127	159	193	259
Jewel	100	146	175	227	357	439

The volume of the sales of Woolworth resulted in a less rapid percentage increase. Jewel Tea and Acme Tea showed great absolute increases in 1917; this was probably due in part to their expansion after their flotations of 1916.

The ratios of profits (profits and interest) to sales show that Woolworth and Jewel Tea probably derived more benefit from their expansions than the other companies, whereas the margin in the case of Acme was small. The percentages of profits earned on sales were as follows:

	1912	1913	1914	1915	1916	1917
Woolworth	8.9	9.7	9.2	9.9	10.0	9.4
Kresge	6.4	6.5	7.1	6.2	7.2	6.2
McCrory	6.7	7.2	6.2	6.3	6.2	4.1
Acme	4.1	5.9	4.2	3.5	3.9	4.5
Jewel	11.7	7.9	14.9	17.9	11.4	9.8

4. *Earnings on Investments*

The returns of these companies were as follows:

	1912	1913	1914	1915	1916	1917
Woolworth	36.8	36.3	36.4	33.9	34.7	32.6
Kresge	27.0	29.0	33.8	29.2	18.0	13.9
McCrory	—	—	—	15.6	17.3	11.7
Jewel	—	—	—	—	24.9	25.0
Acme	—	—	—	—	25.0	34.9

All of these chain stores earned large percentages on their investments, except possibly McCrory. Woolworth made exceptionally high returns on investment. Acme and Jewel also earned large profits on investment.

5. *The Preferred Stocks of the Chain Stores*

The preferred stocks of the five and ten cent chains were especially conservative. The ratios of the tangible assets to the preferred stocks were as follows:

	1912	1913	1914	1915	1916	1917
Woolworth	100.0	122.4	140.7	159.7	185.7	210.5
Kresge	122.3	150.0	170.0	224.6	340.0	420.0
McCrory	—	—	—	180.0	194.9	219.4
Acme	—	—	—	—	104.5	148.5
Jewel	—	—	—	—	148.5	174.1

The market prices of the preferred stocks were as follows:

	1912	1913	1914	1915	1916	1917
Woolworth	118–109	115–109	118–112	124–115	126–123	126–113
Kresge	105–100	102– 96	105– 99	112–104	12–10[a]	11 3/8–8 3/4[a]
McCrory	—	—	—	—	—	—
Jewel	—	—	—	—	113–104	112– 90
Acme	—	—	—	—	98– 93	96– 92

A higher price than the redemption value ($125) for Woolworth preferred stock was reached in both 1916 and 1917. Kresge preferred stock would probably have risen higher had it not been for the redemption value. The value of these preferred stocks rose as the earnings were accumulated to increase the assets and replace the goodwill.

[a] Reorganization (Par value $10.00).

6. *The Common Stocks*

The percentages earned on the common stocks of these companies were as follows:

	1912	1913	1914	1915	1916	1917
Woolworth	12	15	20	23	20	17
Kresge	9	11	11	13	16	17
McCrory	—	—	—	5	7	5
Jewel	—	—	—	—	10	11
Acme	—	—	—	—	14	25

The comparatively large common stock issues of McCrory and of Jewel Tea explain the smaller percentages earned on those common stocks in 1916 and 1917. The companies in this group, however, were not so much overcapitalized as those in some of the other groups.

The prices of the common stocks were as follows:

	1912	1913	1914	1915	1916	1917
Woolworth	118–76	112–81	103–89	120–90	141–118	155–100
Kresge	89–47	83–58	105–81	260–99	16– 10[a]	13– 10[a]
McCrory	—	—	—	55–50	—	—
Jewel	—	—	—	—	96– 67	78– 31
Acme	—	—	—	—	69– 51	58– 52

These stocks show no close relations to the earnings on the common stocks.

[a] Par value reduced from $100 to $10.

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VITA

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